Directors’ Alert
Through the eyes of the board:
Key governance issues for 2015

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After several years of focusing on containing costs and retaining market share, many organizations believe 2015 will present the best growth environment in close to a decade.

The U.S. economy is showing signs of a strong recovery, oil prices are falling, and digital technologies—while disrupting some business models—have created new opportunities for organizations that have leveraged those technologies to their advantage.

That is not to say things could not change dramatically. Geopolitical tensions could have a sudden and negative regional or global impact on the economy. If so, with interest rates in most jurisdictions at record lows, central bankers would have little stimulus room, and already there are concerns about deflation in Europe and other markets.

Stakeholders will be watching to see how well organizations navigate this environment—how they seize its opportunities and mitigate its risks—thereby placing their boards clearly in the spotlight. Every board will need to effectively address a wide range of issues, from ensuring that the organization attracts the talent and develops the leaders it needs to achieve its strategic objectives to re-examining its own membership to make sure it has directors with the knowledge, expertise, and experience to address all of the issues of an increasingly globalized and digitally disrupted marketplace. A significant challenge for many boards will be to clearly present the organization’s story to its key stakeholders, from shareholders who want more transparent disclosures to employees who want assurances that the organization shares their values and is a good corporate citizen.

This publication examines these and other major challenges likely to affect organizations and their boards of directors in 2015. Our objective is not to provide solutions to the issues discussed since the best approach for every organization will depend on its own particular circumstances. Instead, our goal is to assist directors in identifying the issues of importance to their organizations, and to help promote boardroom discussions around the strategies and options management has put forward to address current and future challenges, mitigate the risks, and seize the opportunities that lie ahead.

To develop this publication, we interviewed specialists from Deloitte member firms (“Deloitte”) around the globe who work closely with boards of directors. We asked them to identify the top issues facing the organizations and boards they work with, and to provide their insights into the opportunities and risks in each area that boards and management should consider when developing their strategies.

We also spoke with three independent directors to discuss the issues and gain their perspectives on them. Together, they provide European, Americas, and Asia/Pacific viewpoints on the challenges and opportunities facing them and their fellow directors.

Each article also includes questions that directors may ask to further explore the issues with their own boards. In addition, several tools and resources are provided at the end of the publication so directors can “dig deeper” to broaden their understanding of the issues and improve their board’s effectiveness in dealing with them. These additional resources can be obtained by contacting your Deloitte partner.
In a VUCA world—one that is volatile, uncertain, complex, and ambiguous—is strategy relevant anymore? According to some, it isn’t. They believe that setting strategy is no longer possible when conditions change at increasing speed, quickly disrupting long standing business models. Perhaps, they suggest, organizations would do better to focus on being flexible, adjusting their initiatives as necessary in response to the changes as they occur in the operating environment. In short, they say, strategy is dead.

Or is it?

In a VUCA world, strategy matters now more than ever. That’s because strategy is an integrated set of aligned, reinforcing, and coherent choices about an organization’s goals and aspirations, about where to play and how to win, and about the capabilities and management systems required to do so. Strategy is the foundation that drives resource allocation, investment positions, performance expectations, and the design of organizational structures. It is the filter through which organizations distinguish opportunities from distractions, helping management make good decisions about what to do, but as importantly, about what not to do. Strategy, therefore, profoundly influences an organization’s position, its potential, and future economics—in short, a well executed strategy is essential to producing superior financial performance over time.

That is not to say that strategy does not need agility and flexibility. Strategy describes explicit choices for the organization, which are underpinned by a set of assumptions about the organization’s industry, competitors, customers, and other factors. Since those factors aren’t static, organizations need to periodically re-verify those assumptions and, when they change, organizations need to recheck the choices they made based on those assumptions, and adapt them if necessary. How often should an organization revisit its strategy and underlying assumptions? The right timeline will depend on the “clock speed” of the industry—the clock speed of the technology industry, for example, is much faster than it is for many other industries.

Boards of directors have an important role in strategy. While management is responsible for setting, refining, and executing the organization’s strategy, the board’s role is to provide oversight and guidance to the direction of the strategy and to weigh its inherent risks.

Part of the board’s responsibility is to clearly set appropriate expectations for management and the organization’s strategy. Boards should neither set the bar too low—not demanding a strategy and simply allowing management to develop initiatives in an ad hoc way without the context of overall strategic goals—nor set the bar too high—setting unrealistic expectations for the organization based on its starting point and resources. Instead, boards should demand that management develop an explicit strategy that reflects a set of choices and considers alternatives, clearly outlining their consequences, tradeoffs, and risks. Boards should also demand that the strategy be coherent; its choices should make sense and reinforce each other; the choices of the markets the organization will enter should be ones that will enable it to achieve its goals and aspirations; its plans should enable the organization to succeed and connect with its current and future customers; and the required resources to carry out the strategy should be those the organization has or can access in the future.

Boards are also responsible for appropriately evaluating the organization’s strategy and its inherent risks. The board cannot afford to receive management’s proposals uncritically, accepting them without question or query. On the other hand, boards should not attempt to drive the strategic process, which would occur when directors move from constructively probing the strategy and its underlying assumptions and risks to actively defining the strategy and advocating its direction. If the board isn’t satisfied with the strategy proposed by management, the board has a duty to require management to rethink and improve that strategy, but it isn’t the board’s responsibility to take over that role from management.

Boards and management need to interact productively when defining and refining strategy. There should be a cadence to the interactions between them; the aspects of strategy and the issues being addressed should develop over time, so that their sessions focus on different aspects of strategy and escalate in quality. In a productive relationship, the questions the board asks should be ones that are purposeful and legitimately probe and advance the strategy without grandstanding or attempting to “one up” management.

As the organization’s primary steward of risk, the board is responsible for defining the risk appetite for the organization. The expectations the board sets around strategy, and its interactions with management, should be viewed in the context of the risks being borne by the organization and its stakeholders, and how those risks are managed and mitigated. Boards need to weigh the organization’s various portfolios, and the risks associated with them, and assess different scenarios that change those portfolios—for example, getting out of one business or into another—and their impact on the organization’s basket of risks.

In a VUCA world, management and boards tend to systematically underestimate the risk of the status quo—the current direction and makeup of the organization—and overestimate the risk of doing something different. Just because the current activities and their risks are known does not mean they are less than the risks associated with doing something different.

While setting strategy may be a greater challenge than in the past, the risks of not setting a strategy are also greater today. Boards should connect regularly, visit the organization’s business units, meet with management, and engage industry and subject matter experts so they can better understand, assess, and challenge the strategic choices made by management and the assumptions that underlie those choices.
Questions for directors to ask

- Does our organization have a strategy that we believe will enable it to achieve its future aspirations? Does the organization have the resources—such as a management team with the appropriate leadership abilities, a workforce with the required skills, capabilities, and expertise, and financial and technology resources—necessary to achieve our strategic objectives? Does our board have the right qualifications for the current environment? If we’re lacking any required resources, what is the organization doing to obtain them?

- What is the board’s working relationship with management? When we interact with management on strategy, is there a constructive, positive dialog among directors and management regarding the strategic choices? Are we confident that management and the board are “on the same page” around strategy?

- How aligned is our organization’s risk appetite with its strategic choices? Are we too risk-averse to consider and fully explore alternative strategy alternatives? Or is our risk appetite so great that we are in danger of making unsound strategic choices?

- Does the board hold strategy retreats, and if so how often? Does each retreat build upon the ones that came before, so the board progressively expands its knowledge and understanding of strategic issues?

Strategy is more important today than ever before, and organizations that believe they don’t need one because they want to be flexible are abdicating their responsibility. The best strategies build flexibility and agility into their set of strategic choices, and organizations review and, when necessary, refine the assumptions and choices underlying their strategy on a regular basis.

Jonathan Goodman, Toronto
Reputation is one of an organization’s most valuable assets—according to a 2012 study by World Economics, on average, approximately 25 percent of a company’s market value is directly attributable to its reputation. It’s also an incredibly fragile asset: a good reputation built through years of dedicated effort can be destroyed almost overnight, especially in today’s interconnected world where an organization’s customers, operations, supply chains, and internal and external stakeholders are scattered globally.

Traditionally, an organization’s reputation suffers as a consequence of a failure, such as a financial or strategic problem. Defective products, poor working conditions, environmental damage, fraud or corruption, and other problems can all have an impact on its reputation. Often, such damage can far exceed that caused by the original problem. For example, organizations are required to disclose cyber breaches, and even a relatively small breach that captures only a few customer records or minor information can quickly draw both regulatory scrutiny and widespread negative public reaction.

Reputational damage can also result from risks outside the organization’s direct control, such as a failure at a third-party supplier or partner, competitive attacks, or natural hazards and other catastrophes.

In today’s world of social media, a blow to an organization’s reputation may go viral even without any actual wrongdoing by the entity itself—perhaps, as a result merely of a perception of inappropriate behavior or even just the grievances of one or two individuals. Such attacks can have a domino effect, creating other risks—typically, impacts on revenue and brand value—that need to be mitigated.

Not surprisingly then, almost 90 percent of executives surveyed by Forbes Insights in 2014 on behalf of Deloitte say that reputation risk is their key business challenge. Because of its significance, the responsibility for managing reputation risk, according to survey respondents, resides at the highest levels of the organization: the c-suite and the board.

Given the rapid speed at which reputation problems can develop, many organizations are looking at ways to improve their capabilities for managing this risk. Technology, such as analytical and brand-monitoring tools, can help identify what matters most to an organization and its reputation. It can also monitor developments occurring at competitors, elsewhere within its industry, or among its business partners.

Others may be able to provide early warning of pending problems as well. Analysts and investors may provide their perceptions of the organization compared to its peers, and since customers and clients are one of the most important stakeholder groups for managing reputational risk, organizations should closely monitor their customer touch points, such as call centers, walk-in premises, and other points of interaction, to keep tabs on what customers think about them.

Organizations are also looking internally to strengthen their ability to detect and mitigate reputation problems. An effective whistle-blower program, for example, can help bring to light problems within the organization that may be compromising its reputation. Some organizations are considering appointing a reputation risk officer to manage reputation risk on a day-to-day basis, while implementing crisis management strategies, including risk scenario planning and response rehearsals, can improve the organization’s effectiveness at quickly resolving reputational issues when they do arise.

The board has a role to play in helping to oversee and advise management and the organization in understanding the potential reputational risks associated with strategic decisions. Independent directors should bring their external perspectives to assist in this process. In some organizations, management presents the strategy by modeling different paths of action and then analyzing the associated risks and opportunities created by different scenarios. The board plays an active role in this discussion by providing perspective and feedback that could lead to changes to the strategic path and the associated identified risks and opportunities.

Organizations need to understand the full parameters of their risk environment. Once an event becomes publicly associated with a company—even if it has no legal connection to that event—it may still suffer reputational damage. Many organizations, therefore, prepare global risk agendas that identify key risks at various levels: by country, corporate level, business unit, etc. Boards should ask management to share its risk agenda and assessment with them, and make reputation risk at least an annual item for discussion.

Questions for directors to ask

- Does our organization have a social media policy and what does it cover? Do we think about social media from a perspective of both risk and opportunity? Is there a designated position in our organization to manage social media? Does our organization monitor social media and, if so, for what? Do we monitor social media internally, or is the function outsourced?

- Does our organization have a crisis management and a cyber incident response plan, not just a business or disaster recovery plan, to mitigate any reputational damage that may result from a cyber incident or other failure? Does the organization practice its response plan and simulate the decisions and actions that will need to be taken under different scenarios? Does the board have an opportunity to observe these simulated response plans as they are being practiced?

- What role would the board have in responding to a reputational incident, and is that role clearly defined? When did the board last respond to a crisis, and was there an assessment of its performance? Were the findings of this assessment built into the crisis response plans of the organization and the board?

- Where does the responsibility for risk and crisis management sit on the board? Is it a responsibility of the full board, or are activities delegated to a committee? If more than one committee is involved, how does the board ensure their activities are coordinated so there are no gaps in responsibility?

The biggest risk an organization faces is not being prepared—that is, not having a risk management process, whereby management identifies, continually assesses, and monitors risks that may have an impact on a company’s reputation. A critical part of the process is being prepared with a fully developed and well-rehearsed response plan since organizations need to act quickly and effectively to mitigate incidents. Boards that set the tone with regards to the importance of such a process and take an active role in overseeing, advising on and continually monitoring enterprise risks, and specifically the reputational risks, will be better prepared to respond to issues when they arise.

Maureen Bujno, New York

One of the biggest reputation risks facing companies today is not embedding cyber risk into their other business and enterprise risks. Boards should question management about how they monitor these risks, and what they have put in place to enable them to respond to an incident. Organizations that are well prepared for a cyber breach, without a doubt, do better in the marketplace.

Mary Galligan, New York

Mary Galligan
Director, Deloitte U.S.
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A director’s perspective

A conversation with Peter G. Bowie

Asian markets have performed better than most in recent years. What are the big issues facing boards in Asia?

The big issues are similar to those facing boards in other parts of the world though they vary in degree. Because many Asian markets are export oriented, the volatility in the world is a concern for boards. Boards are looking at the falling price of oil and the impact that it is having on the Russian economy, the continuing weakness in the European economy, and a slowing in China’s exports, and they are trying to determine how all of that might impact their organization and its business model, and what their organization needs to do in response. The strengthening of the U.S. dollar, for example, could potentially have a very significant impact depending upon the extent to which a company has borrowed on the international markets in U.S. dollars and is paying off those debts in their local currency, which would make those loans much more expensive and difficult to finance.

Another concern for Asian companies is cybersecurity. The number of cyber attacks is accelerating and the attention boards and organizations are focusing on cybersecurity is growing.

Succession is also an important issue for Asian businesses. Asian markets are characterized by family-owned companies, so succession and keeping the family intact is something that generates a lot of discussion.

Increased regulation is a concern in North America and Europe. Is it also a big issue in Asia?

Asia doesn’t have a single regulatory regime; it varies from country to country. Generally, however, the governance structures, rules, and regulations in Asia have been evolving and maturing, and that continues to be an ongoing process. I spent time on the Council of the Asian Corporate Governance Association, which together with Crédit Lyonnais Securities Asia, a leading Asian brokerage and investment firm, conducts an annual survey of the corporate governance practices in the major Asian countries. Those surveys have shown tremendous changes in governance over the years, and generally for the better.

There has been an increase in regulatory requirements, but in many cases it is not as onerous as in other major markets. In China, we’ve seen the introduction of CSOX, which is the Chinese equivalent of Sarbanes-Oxley, and the Shanghai and Hong Kong stock exchanges have also introduced a number of changes to their listing requirements, and so boards do spend more time reviewing the extent to which they and their organizations are complying with all of the rules and regulations. But, in my view, it is an evolution in governance that will continue for some time as the rules and regulatory regimes continue to evolve.

Organizations in Europe and North America are increasingly being targeted through social media and activist investors. What’s the situation in Asia?

Social media attacks on organizations have been an issue in Asia for quite some time. In some cases, the attacks are launched by people trying to leverage their own particular position. In other cases, however, companies that have had product problems or other issues and have been attacked quite heavily by social media. That can be particularly devastating for a company, so it is definitely a big issue.

Activist incidents, on the other hand, are not nearly as prevalent in Asia as elsewhere. Japan has probably seen the most challenges, where companies have been targeted, but generally not successfully. It’s very difficult to move into markets like Japan, China, or Korea if you don’t understand the marketplace. You can’t be successful if you approach Asian markets with a perspective or viewpoint that may be unique to the North American market.

Disclosure overload and transparency are other big issues globally. What can be done about it?

It’s an issue in Asia as well. I saw one global financial institution’s annual report, which is 600 pages long, making it virtually impossible for the average person to gain a clear picture of the company. Activist investors and institutional investors can do it, but only because they can afford to hire a team of young MBAs to work full time analyzing companies and their disclosures.

2 The Sarbanes–Oxley Act of 2002, also known as the “Public Company Accounting Reform and Investor Protection Act” and “Corporate and Auditing Accountability and Responsibility Act”.

Peter G. Bowie is a member of the boards of directors of China Cosco Holdings Co., Magna International Inc., Uranium One Inc., and is the chair of the board of Cederberg Capital. He is a former member of the Council of the Asian Corporate Governance Association and from June 2003 to May 2010 was the CEO and senior partner of Deloitte China.
In terms of what can be done: With all of the technology that is available today, there has to be a way to present information in a way that allows users to decide what they want to know about the organization, whether it is a high-level overview or a desire to drill down to whatever level of complexity suits their taste. But I don’t see any great movement in that direction, perhaps because organizations aren’t being pushed to do it. Typically, the pressure on companies come from institutional investors and the investment community, but as I just noted, they have their teams of MBAs analyzing company disclosures, so they don’t seem to see the need to push for a change.

You mentioned cyber attacks, which seem to be one of the biggest reputational risks companies face today. How are boards responding?

Cyber and reputation risks have become top concerns for all boards and organizations. According to some research by IBM Security Services, security events occur every second of the day, either by insiders or external parties, and inevitably some will succeed. Every organization will eventually be hacked, for whatever reason the hackers think is important. Several recent attacks have not gone after financial information but have instead stolen seemingly innocuous data, such as the private information about the company’s employees. Every organization is a potential target with information about its employees that must be protected. Boards realize that this is becoming an ever more risky environment, and that the organization has to take steps to actively defend itself. It’s not just defense—dealing with and, hopefully, repelling cyber attacks and other IT risks—it’s also offense: having a plan in place to deal with cyber attacks or other reputational problems once they occur that sets out, in advance, who will be responsible in the organization for responding and what actions will be taken. The window for responding is very narrow—organizations have to very quickly demonstrate that they have taken control of the situation if they are to protect their reputation.

What will be the big issues in 2015?

Volatility looks as though it will be the big concern. The U.S. economy is going to continue its growth, but offsetting that will be weaknesses in Europe and Asia. Interest rates will generally remain flat, but debt levels are quite high and that will cause problems when interest rates do finally begin to rise. Oil prices are falling, and we don’t know what the full global effect of that will be, but we are seeing its impact on the Russian economy and the ruble. There are geopolitical issues bubbling in various parts of the world and we don’t know what might happen with them. So these are all issues that boards have to monitor and also anticipate different scenarios. They need to assess the impact on their marketplace, their industry, and their organization.

The other big concern is cybersecurity, and that will be a major concern not just in 2015 but for several years to come. Some of the hacking is by criminal organizations, some of it is state-sponsored, and there appears to be a lot of money involved, so it isn’t going to fade away. Given the apparent ease with which some of these hackers are able to do what they do, and the extent of the damage they can cause, it’s a very serious issue that boards really need to address actively.
Subsidiary governance

Balancing roles and responsibilities between parents and subsidiaries

Differences between national regulatory requirements and the need to manage global risks have made subsidiary governance a growing challenge for multinational organizations.

Corporate governance regulations and practices differ from one jurisdiction to another, making a “one size fits all” governance structure challenging for multinationals to apply to all of their units. For example, under the King III Report, listed South African subsidiaries of non-South African multinationals are required to apply the King III principles, even if they differ from the governance policies and principles of their parent.

From a risk perspective, unidentified and/or unmitigated risks at the subsidiary level can quickly escalate to and consume the parent organization. In the past, many global organizations were either unaware of or didn’t understand the risks of their subsidiaries until a problem occurred. Today, with the speed at which information circulates globally, organizations must be proactive in understanding their subsidiaries’ risks to allow them to respond effectively and in a timely manner if problems arise.

A key issue for multinational organizations is to determine how they will extend sound corporate governance practices and policies downstream to their subsidiaries. Stakeholders generally judge multinationals by the values of the parent in its home jurisdiction, and problems arising at the subsidiary level can affect the brand and reputation of the parent. However, setting an appropriate tone at the top and applying values consistently across subsidiaries in all jurisdictions may be difficult because of differences in local regulations and business, employment, and other operating conditions. The parent must be careful not to be too heavy-handed—being viewed as a “colonizer” in the subsidiary’s jurisdiction—without compromising its core values. A leading practice would be to ensure the parent’s governance practices are adopted by all of its subsidiaries, even if they are not required under local regulations. When differences in requirements exist between local rules and the parent’s practices, the organization should adopt the most rigorous ones.

Another important issue for multinationals is determining the governance structure that would best contribute to an effective chain of oversight for the full organization.

A Deloitte survey found that almost three-quarters of global organizations have separate boards of directors for their subsidiaries, and most have some common directors on the boards of both parent and subsidiary companies. The same survey found that almost 70 percent of parent-company boards spend significant time overseeing the business and risks of subsidiaries.3

The governance framework should clearly set out the roles and responsibilities of both the parent and subsidiary boards, including key performance indicators for each. It should also identify issues that must be elevated from the subsidiary to the parent board, or which require the approval of the parent board. Effective two-way communications between the boards is also important, so the framework should set out how and when issues should be communicated.

Multinationals should revisit their governance structures periodically to ensure they remain appropriate. Changes in operating and regulatory conditions may also necessitate changes. The board of a recently acquired subsidiary may have more limited autonomy until the parent board is satisfied that its values and practices have been implemented appropriately. A parent board may also choose to assign different roles, responsibilities, and autonomies to the boards of larger subsidiaries than it does to those of smaller ones.

3 “Governance of Subsidiaries: A Survey of Global Companies”, September 2013, Deloitte India.
Questions for directors to ask

- How well do we understand the risks associated with our subsidiaries, and how are those risks being mitigated? Is there anything about the business practices or activities of our subsidiaries that might affect the reputation of our overall organization?

- How well do we understand the local regulatory requirements that are applicable to our subsidiaries? Are there areas where these requirements conflict with the governance practices of the rest of our organization?

- How much time do we, as a board, spend on issues associated with our subsidiaries? Are we spending too much or too little time on such matters?

- Have we put in place a governance framework that clearly sets out the roles and responsibilities of both the parent board and the subsidiary boards? Does it clearly indicate matters that must be reviewed and approved by the parent board?

- Do we have clear and open communications between the parent and subsidiary boards? How does one board bring matters to the attention of another? Do we, or should we, have some directors who sit on both the subsidiary and parent boards?

The subsidiary board’s role is to oversee the strategy and objectives, business operations, and the management of the subsidiary. In addition, both the subsidiary board and parent board have a responsibility for seeing that the parent company’s values and overall strategic direction is maintained by the subsidiary.

Sachin Paranjape, Mumbai

Striking the appropriate balance between the roles of the parent and subsidiary boards can be challenging and different organizations will allocate that balance in different ways, depending on the organization’s culture. The relationship between the boards should be re-evaluated periodically to ensure that it continues to work effectively.

Rami Adel Wadie, Kuwait City
Almost a decade has passed since Norway enacted a law requiring that 40 percent of board members of publicly listed companies be women. Since then, other jurisdictions have introduced similar requirements, some of which make gender diversity mandatory for public entities while others set gender quotas to which these entities are required to either comply with the requirements or explain their reasons for not complying.

In November 2013, the European Parliament voted to back a European Commission proposal that would require publicly listed companies with revenues of at least €50 million and more than 250 employees to have 40 percent women directors on their boards by 2020. In July 2014, France passed legislation reinforcing the application of the Copé-Zimmermann law (2011), which requires public companies with revenues of at least €50 million and that employ more than 500 workers to have 40 percent women directors on their boards by 2017.

In Canada, the Canadian Securities Administrators require listed companies to disclose their policies for women directors, the number of current women directors, and their targets for women directors on a comply-or-explain basis. Meanwhile, the Canadian Senate is considering legislation that would require at least 40 percent women and 40 percent men on the boards of public companies, state-owned enterprises, and certain financial institutions. These are just some of the regulatory measures regarding gender diversity being undertaken around the world.

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In many jurisdictions, institutional investors have stated that they will not invest in companies that don’t have sufficient gender diversity on their boards. In October 2014, for example, the Thirty Percent Coalition, led by the California State Teachers’ Retirement System, sent a letter to 100 boards. In October 2014, for example, the Thirty Percent Coalition, led by the California State Teachers’ Retirement System, sent a letter to 100 companies in the Russell 1000 Index that do not currently have women on their boards urging them to embrace gender diversity.

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All of these developments have resulted in boardroom gender diversity reaching a tipping point, according to Catalyst, a not-for-profit organization seeking to expand opportunities for women and business. Not only are demands for gender diversity higher than ever among legislators, regulators, and investors, but also among boards themselves. Studies of Fortune 500 companies have found that the most gender diverse boards performed better with higher returns on sales and equity than less diverse boards. In addition, a 2012 survey of U.S. directors found that three-quarters said their companies had taken steps in the previous three years to promote boardroom diversity, and 80 percent said diversity in the boardroom generally results in greater value for shareholders.
Questions for directors to ask

- Are there regulatory or legislative gender diversity requirements that apply to our board? Are we on-track to meet or surpass those quotas by the effective date? Have we communicated our expectations around gender diversity to the organization’s major shareholders and other stakeholders, including those within the organization?

- Does our board have a sufficient diversity of thought among its members? Do we, as a board, feel we have the collective experience and expertise to be able to understand and address all of the key risks and opportunities facing our organization, including those created by digital disruption and increased global competition?

- When we have recruited new directors to the board, were we able to find director candidates with the required skills and knowledge? Do we need to broaden our search to look for candidates outside our traditional recruiting pools?

- Does our board function effectively as a team? Is there a sense of trust among directors and between the board and management? Are there ways that the board could improve its performance and, if so, what are they?

Digitalization and increasing global competition will require boards to have members with more diverse competencies and experiences than in the past. Boards that are too slow to adapt could face significant risks while boards that continually review and update their board profiles and keep an ongoing focus on finding appropriate board candidates, will succeed.

Bjorn Mikkelsen, Stockholm

Latin American boards are focused on the elements that create boardroom effectiveness. In addition to gender diversity, they are looking at the overall composition of the board, including the independence of its directors, the combined skills and knowledge of the board, and whether or not the board works together as an effective team.

Gerardo Herrera Perdomo, Lima
Regulation

From catch-up to cultural change

For more than a decade, organizations have faced a deluge of new and more onerous regulatory requirements. Sarbanes-Oxley in the United States and similar rules in other jurisdictions were implemented in the wake of Enron and other failures in the early years of this century, and additional regulatory initiatives followed in the wake of the 2008 financial crisis. For many organizations, simply catching up to the requirements of the new rules and ensuring they are compliant has been a full-time task.

And, further regulatory initiatives are on the horizon.

The OECD has initiated a Base Erosion and Profit Shifting (BEPS) project which, if adopted by G20 nations and others, will significantly change global tax rules. BEPS refers to tax planning strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations where there is little or no economic activity, resulting in little or no overall corporate tax being paid.

Anti-bribery, anti-corruption, and anti-fraud measures are also an increasing focus of many regulators. While some jurisdictions believe more rigorous implementation of the current rules will be sufficient to address problems, others believe tougher rules may be required. In some instances, senior officers have been found personally liable for their organization’s failure to implement sufficient anti-corruption measures; in other cases, organizations have had to pay significant penalties for not meeting requirements to protect personal data.

Pay ratios and executive compensation policies are another high priority in certain jurisdictions. The European Commission, for example, has proposed rules around “say on pay” that will give shareholders a binding vote on management compensation, while Dodd Frank in the United States gives shareholders a non-binding vote on pay. A variety of measures have been implemented or are being contemplated to further shape organizational behavior, including requirements to disclose the sources of precious metals, political contributions, environmental impact, executive health, and the representation of women at the board and management levels.

As organizations struggle to meet the many new regulatory requirements being imposed, many have yet to make the cultural changes necessary to adapt their business models to the changing regulatory landscape. Doing so will be a key priority, since the heightened pressures that have existed since 2008 are unlikely to ease in the future—and may well increase, given that social and media pressures are increasingly setting regulators’ agendas.

Organizations also need to be mindful of social and media concerns since they are becoming as important as regulatory measures in affecting the way entities operate and the perceived acceptability of their business strategies and practices. This is a difficult process. Public perceptions of an organization and its business activities can change quickly with little warning, and organizations may suddenly find themselves out of step with their customers and other stakeholders.

Boards should ensure that regulation is a topic on their agendas, at least annually, and management should be asked to report to the board on new and proposed regulatory changes and their plans for responding to them.

Boards and management should also have open lines of communication with regulators, legislators, and industry associations in order to discuss proposed rules and the impact they will have on the organization and its business, and alert regulatory authorities to any unintended consequences or unnecessary burdens that may be created by a proposed rule change.

New European rules regarding auditor rotation will affect European-based public interest entities (PIEs), which include companies listed on a European Union (EU) regulated market and certain credit institutions and insurance undertakings in the EU (whether or not they are listed). The legislation will primarily affect non-EU companies only if they have operations in the EU that are considered PIEs in their own right, such as EU-based banking or insurance entities or EU-incorporated subsidiaries that are themselves listed on a regulated exchange in the EU.

These rules are likely to vary from one country to another as companies enact various implementation options. The legislation will require rotation of the statutory audit firm of a public interest entity after a maximum of 10 years, but allow individual EU member states the ability to set shorter rotation periods. However, individual EU member states can extend the maximum term to 20 years if there is a competitive tender after the first 10 years, or 24 years, in the case of a joint audit regime (which currently is only required in France).

As EU member states adopt the options over the next two years, organizations that will be affected by the new law should monitor the final requirements in relevant countries, including to determine when their organization may be required to tender the audit, as well as the independence requirements for potential future auditors of their organizations.

8 The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Subtitle E-Accountability and Executive Compensation.
Questions for directors to ask

- How well-prepared is our organization for proposed regulatory changes? Do we have a process in place to ensure that we will be compliant with the new rules? Have we assessed the impact the proposals may have on our business strategies and activities? What actions do we need to undertake to adapt our business to these changes?

- Does our organization monitor social media, traditional media, and other sources to determine the public perception of our organization and the public acceptability of our business strategies? Do we monitor the public’s opinion on our competitors and our industry?

- How often do we, as a board, discuss regulation? Are we receiving the appropriate information from management to enable us to understand what proposals will affect our organization and what we need to do to respond?

- Does our organization work with peers and others in our industry to ensure that a dialog exists between directors and the regulators, so we can make our collective concerns known in order to minimize the collateral impact associated with adapting to the new rules?

- What impact will regulatory changes—for example, gender-diversity requirements and shareholders’ votes on compensation—have on the board itself and on the organization’s corporate governance system? Do we need to reassess our directors’ and officers’ insurance coverages in light of some jurisdictions indicating they intend to hold officers personally liable for their organization’s actions?

In the past, it was assumed that organizations would act in an ethical or honorable manner. We’ve seen many situations where that is not the case, so a lot of recent regulatory measures have a social or ethical focus to correct this situation. This has resulted in a convergence of regulation, social concerns, and media pressure that is shaping the business environment.

Claus Buhleier, Mannheim

There has been a tremendous increase in regulatory pressure since 2008, and while organizations need to respond to this they cannot afford to neglect social and media pressures, which have also increased. There’s a big opportunity for them and their boards to proactively demonstrate that they have not just responded appropriately to new regulatory requirements, but that they’ve also adapted to changes in the mindsets and values of the organization’s wider stakeholders.

David R. Hawley, London
What were some of the big issues facing boards of directors in 2014?

The circumstances of each board and organization are different, so the top issues for one board may not be the same as the top issues for another. But there are some things that I believe most boards and organizations need to address. The first is the impact of globalization, and specifically the increase in country risks over the past few years. Another issue faced by every board and organization is digitalization and innovation, which is changing and disrupting business models in a dramatic way. This is something every board needs to monitor very carefully.

Regulation would seem to be another big challenge for many boards. How are they coping?

It is a challenge since there have been a lot of new regulations introduced in recent years, some of which apply to the board and some to management. But the challenge goes beyond just dealing with the new regulations; there are also the regulations in the pipeline that will need to be addressed in the future. Then, in addition to formal regulation, there is a growing concern that not everything that is legal is also legitimate so we’re seeing a growing amount of public attention focused on an organization’s business and tax practices. Addressing all of this takes an enormous amount of time just to ensure that the board and the organization are fully compliant with the new rules as they come into effect. There is a risk that by becoming so focused on compliance, the organization might become less entrepreneurial—less likely to be looking at the rule changes with the intention of determining whether they create business opportunities for the organization.

How well are organizations responding to this public attention? Are they getting their messages out?

A big challenge for organizations addressing social groups is determining not just the content of their message, but also the channels they use to deliver it. Organizations tend to communicate on a different channel, often through the traditional media such as the leading newspapers, while social activist groups communicate in a totally different way using social media. The channels the organization uses to deliver its message influences the perceptions people have about that message and the organization. Many organizations are still adapting their communication strategies, particularly in order to communicate with these social groups, which requires them to move away from the traditional channels to social networks, which can be challenging because these other channels are less familiar to them.

What pressures are activist investors and other investors putting on boards?

A big development over the last decade is that investors now have different time horizons, and activist investors may have very different time horizons from other investors. That creates an issue for the board, which is: what strategy should the organization follow, and to what extent should the organization communicate that strategy to investors and others?

There has been an increase in activist investor activity in Europe over the past few years, and part of the problem is that, unlike North America, many European countries have two-tiered boards—a supervisory board and a management board. The supervisory board may want to have an improved dialog with investors and proxy advisors, but it is only permitted to communicate about corporate governance issues; it is not the body that makes decisions related to the organization’s strategy. But that is changing. A lot of international media are not familiar with the legal framework of a two-tier board structure, and they are pressing supervisory boards to comment on strategy. As a result, we’re seeing supervisory boards becoming more involved in strategy than they have in the past.

Organizations disclose a great deal of information, but has the size of the disclosures impeded the ability to communicate a clear message?

Often, “less” is “more” when it comes to disclosures, but at the moment I do not see any streamlining of disclosures likely to take place. We had a similar debate 20 years ago when there was a big movement to try to reduce the various accounting regulations, but in the end not much changed.
Today, when we look at corporate governance rules and the required disclosures, there are two different ways of approaching these requirements. One approach is to do so from a business perspective; the other is to view the disclosures from a legal perspective. In Germany, a company may believe it is fully compliant with all of the corporate governance rules, but on the slight chance that it isn’t, the company will opt to pre-emptively declare that it may not be compliant. By doing that, they know they won’t be caught on the wrong side of the Corporate Governance Code requirements. That’s not something the Corporate Governance Commission likes companies to do, but the legal pressures are too great.

No company wants to be sued and attract all of the negative publicity that would entail so they choose to disclose everything just to be safe. Unless the rules are changed, I believe we will continue this spiral of organizations disclosing ever greater amounts of information for quite some time to come. Reputational risk in general seems to be increasing. How much attention do boards pay to this?

Reputation risk is increasing and it does take a lot of time at the board level, but I don’t see the organization as always being a victim. Take the case of a supplier that did something wrong. Companies have a set of values and a code of ethics and they need to ensure those values and codes are applied to their business partners. Multinational companies need to ensure their values are applied wherever they operate, even if that means, at times, they differ from the local practices of some countries.

Earlier, I noted that a business practice may be legal, but still not be viewed as legitimate, and when it comes to an organization’s reputation this is an important distinction. It is also important that, when making decisions, companies must not only consider the present perception of those decisions and business practices, but also how they might be perceived in the future. If a problem arises because of a choice made years ago that was acceptable at the time, that choice will still be judged according to today’s standards.

What steps should companies take to help mitigate this problem?

I believe it comes back to the organization’s core values. Decisions about business strategies and practices should reflect those values, and organizations need to ensure that those values are being respected.

At GDF Suez, I’m a member of the ethics committee, and we take a very structured approach to ensuring that the organization acts in a way that is consistent with its values. We have identified our values, and we monitor their development in terms of specific KPIs that we have related to ethics, the environment, and sustainability. If an issue arises, we review it from the perspective of learning from it so we can make improvements in the future. I think, from a corporate governance perspective, this is a leading practice that I believe a growing number of boards of German companies will adopt.

But let’s come back to a situation where a relatively minor problem gets blown into a huge public issue that causes reputational problems for the company. Even when every effort is made to ensure the integrity of the company’s values, problems can still occur given that we’re all human and mistakes sometimes get made. In this situation, I believe that the reputation and credibility that the company has built in the past is very important. Some organizations believe they should stay out of the public eye, and the less media attention they have, the better. But when a scandal suddenly hits them, that may be the first thing people know about the company, and they will judge the company based on it. On the other hand, companies that have built up communication channels and have built credibility in the market will be better able to deal with any problems that arise since those problems will be viewed in the context of all of the organization’s other positive attributes.

What issues do you expect to be on board agendas in 2015?

I expect the top issues will be much the same as the ones that were board priorities in 2014. For example, digitalization and the disruption that it is causing will continue to be an issue—from a European perspective, that will mean focusing on innovation. In the past, European companies have been very good at incremental innovation, which has resulted in an improvement in products over a longer term. Because of the disruptive change created by digitalization, companies need to move from being incremental innovators to learning how to leverage disruptive innovation to change processes, structures, and their whole approach to doing business. That is something that has traditionally been more a part of the American model than the European one, but it is something European companies need to do.

Boards of multinational companies will need to focus on the economic changes that have resulted in tremendous growth in many emerging markets. I expect multinational companies will realign their organizations to take advantage of these developments. Energy prices are an important issue for European companies, so we may see some moving operations to places with lower energy costs. There are also global human resource issues that multinational companies need to manage from one country to another.
Digital disruption and what creates value for the organization

Around the globe, organizations of all types and in all industries are seeing their long-standing business models becoming digitally disrupted. While the digital revolution affects almost every aspect of business, digital technologies are having their greatest impact in two areas.

First, technologies are transforming the customer experience. Increasingly, organizations are being enabled to tailor the products or services they offer to the unique preferences of each customer. Second, they are transforming the way organizations deliver their products or services, allowing customers to obtain products and services when and where they want them.

Because of the speed at which business models can be disrupted by new technologies, business-model risk has become a major strategic risk. Research by Deloitte has found that consumers and investors are rewarding organizations at the forefront of the digital revolution. Many traditional companies, however, have yet to fully determine how best to utilize digital technologies such as cloud, analytics, social media, and mobile.

Responding to the challenges created by new technologies can be difficult for organizations that have taken years to develop their current business processes. Transforming them digitally at high speed to keep pace with outside developments is not an easy task. Making the wrong choices may even leave a company in worse shape than if it had not taken any action at all—a perfect recipe for risk inertia.

While digital technologies can create opportunities in many areas, the benefits may come at the expense of its traditional business. Enabling customers to interact with the organization online, for example, may result in fewer customers visiting the company’s brick-and-mortar outlets. Creating a seamless customer experience across both virtual and real worlds has been difficult for many organizations, and while technologies can erase distance and other communication barriers, automated processes may struggle to deal with unexpected scenarios. Despite these challenges, however, Deloitte research has found that every organization that does capitalize on digital technologies has the potential to improve shareholder value and long-term performance. Coming to grips with today’s new technologies and figuring out how to optimize their use in the organization may be difficult for directors and c-suite members who are of a generation for whom social media and other such advances have only a minimal impact on their personal lives. Organizations that involve everyone at all levels in reviewing processes to identify ways to benefit from new technologies may succeed in digitally enhancing their businesses from the bottom up. In this scenario, the role of the board and c-suite is one of risk oversight and setting strategies to ensure that technologies are used appropriately.

While understanding the future impact of technologies is management’s responsibility, boards should ask management for their perspectives on how the organization is handling the strategic risks related to technology and digital disruption today. In particular, boards should inquire about the organization’s technology strategy and how it is integrated into the overall business strategy, with a focus on what creates value for the organization and how that could become either disrupted or enhanced by technological developments. Moving the company ahead does not necessarily depend on discovering a new game-changing technology; using existing ones to make small enhancements to optimize things that are important to the business, its customers, employees, and business partners can, collectively, make a significant difference.

Questions for directors to ask

- How knowledgeable are we, as a board, about digital technologies? Are we personally comfortable using today’s technologies, such as social media? Do we feel we understand the trends and impact that technologies are having on our industry and our organization?

- Does the board need a better understanding of digital disruption? If so, how should we enhance our knowledge: through education sessions or retreats; engaging outside advisors or experts to review the organization’s business model and identify areas of opportunity or risk; recruiting new directors who have digital expertise?

- When we review and approve the organization’s plans and business strategies, do we give enough consideration to the impact of technology? Should we ask the CIO to discuss the organization’s technology strategies and activities with the board?

- What use does our organization make of data analytics? Do we have people in the organization with the capability of turning data into insights which, in turn, lead to actionable management decisions?

- What is happening with our competitors and supply chain partners? Are their operations being impacted—either positively or negatively—by digital technologies, and if so, what lessons can we learn from their experiences?

Technology can either disrupt or enhance an organization’s business. Organizations that focus on what creates value for the business, its customers, employees, and business partners, and the costs the organization incurs to deliver its services or products to the market will have a good framework for assessing the impact, opportunities, and risks technology may have on the organization.

Philip Chong, Singapore

Technology is driving change at high speed, and in many organizations the traditional skill sets of management do not leave them well prepared to respond. Organizations need people who understand this environment. Data analytics will provide insights at a faster rate, enabling management to more quickly see and analyze the potential impact of their decisions.

Daisuke Kuwabara, Tokyo
After several years of weak global economic performance, organizations are positioning themselves for growth. However, the challenges they now face are significant.

The 21st century workforce is different from its predecessors. It is more global, more highly connected, more technology-savvy, and more demanding than the workforces of the past. It is also more dispersed and diverse based on a variety of measures including age: today’s workforce includes both younger (the millennials) and older (the baby boomers) workers, and each generation has different needs and expectations.

Technology continues to transform all aspects of the workplace, including recruiting, education and training, and analytics. It has also created a new phenomenon: the overwhelmed worker; organizations need to find ways to absorb and adapt technologies, while also making them simple.

Social, political, and regulatory pressures are changing perceptions of organizations. Today’s workers are very aware of an organization’s mission, purpose, and values. To attract, engage, and retain them, organizations need to demonstrate a commitment to corporate social responsibility.

According to a Deloitte global survey, many organizations are facing four major human resource needs.

1. **Global leadership development.** Organizations need to more quickly develop leaders at all levels, in all geographies, and across all functional areas. Many organizations are changing dramatically, a result of globalization, digital disruption, and other factors, and therefore they may need to look for potential leaders from outside their traditional pools of talent if they are to find the people with the skill sets they need in their new operating environment.

   Developing leaders involves more than just finding and developing people with the required technical skills. Leaders also need to have the necessary “soft skills”—the ability to build teams, inspire performance, and work as business partners with the leaders of other functions and business units—if they are to succeed.

   To develop all of these skills will require a variety of learning programs, including traditional training sessions, acquiring expertise through online on-demand learning programs, and mentoring programs through which current leaders can share and transfer their knowledge and expertise to the next generation of leaders.

2. **Retention and engagement.** Today, the demand for top-skilled, top-talented employees is greater than the number of workers with those attributes. Organizations, therefore, need more focused strategies for attracting and retaining key people. Today’s employees want a passionate and compassionate place to work. Career growth remains important to them and compensation can take forms other than just monetary remuneration, including providing flexible work arrangements, job sharing, and allowing employees to bring their own technologies to the workplace. Through the feedback received during employees’ annual performance assessments and employee commitment surveys, organizations can better understand what their employees value, and how well they are meeting those expectations.

3. **Retooling the HR and talent functions.** HR needs to be transformed if it is to be successful in meeting the talent challenges facing the organization. In many organizations, HR’s focus continues to be on administering people rather than on enhancing people’s performance.

4. **Talent acquisition and access.** Finding, attracting, and accessing highly skilled people is critical in an environment of changing workforce expectations, shrinking half-life of skills and technical knowledge. Social media has changed recruiting into a strategic function based on marketing, branding, and new tools and technologies.

While the needs are clear, the Deloitte survey also found that few organizations believe they are prepared to respond. Organizations recognize the need to take action, but are uncertain whether they have the ability to deliver results. Many organizations, for example, are making use of data analytics in their business, particularly in finance and operations. Few, however, have analytics capabilities in their human resource group. Implementing these capabilities could enable organizations to better manage their people, by allowing them to anticipate trends related to retention, advancement, and other attributes.

Questions for directors to ask

- How well do our organization’s talent strategy and talent management practices align with our business strategy? Are we confident that we will have enough people with the skills we need to execute our strategy successfully?
- What is our organization doing to develop leaders for tomorrow? Are we developing both their technical expertise as well as the softer leadership skills? Have we considered mentorship programs to help develop leaders and, if so, is there a role for board members to play as mentors?
- When the board sets its performance objectives for management, do we set objectives for management in the area of leadership development?
- How well does our organization understand key human resource trends? Do we need to invest in data analytics so we can improve our understanding, and ability to predict, trends such as rates of attrition, predict employee performance, and better plan and manage our workforce?

Many organizations have ambitious plans for growth, but to achieve those objectives they will need to develop new talent strategies and transform their human resource functions if they are to be certain of having sufficient people with the right skills to achieve the organization’s business objectives.

Jorge Ponga, Mexico City

“Many organizations have ambitious plans for growth, but to achieve those objectives they will need to develop new talent strategies and transform their human resource functions if they are to be certain of having sufficient people with the right skills to achieve the organization’s business objectives.”

Jorge Ponga
Partner, Deloitte Mexico
Contact me on LinkedIn
Organizations should also regularly monitor market activity to identify any changes in their market, their shareholder mix or in shareholder behaviors. They should also pay close attention to activities in their industry, especially if one of their industry peers has been targeted by activists or has received negative media attention or analyst comments.

Boards and management should also have plans in place that will enable them to respond quickly to any activist shareholder inquiries. Part of that plan should be proactive: organizations should maintain a regular and ongoing dialog with their key shareholders and other stakeholders to regularly confirm their support for the organization, its strategies, and other activities, such as sharing strategies about succession, remuneration, and other governance matters of primary concern to all stakeholders, especially activist ones. The feedback will help identify any areas that might attract activist attention, while also ensuring organizations have obtained the buy-in and support of their key shareholders for their decisions and actions.

Organizations that do attempt to better engage their stakeholders may still find themselves questioned by shareholders. Every organization, therefore, needs to be well-prepared and ensure they understand their vulnerabilities and exposures, and be prepared to explain and defend the actions, strategies, and policies that may attract activist shareholders’ attention. Management and the board should also have a clear, fact-based understanding of the organization’s short- and long-term value, including the value of the organization and its component parts under different alternatives and scenarios, which it can use to defend its decisions if they are questioned by activist shareholders.

Activist shareholders have long been a feature of U.S. capital markets, but in recent years they have become more prevalent in Europe and other jurisdictions, and the number of global campaigns has increased significantly. Typically, activists’ concerns are to address management-related issues such as remuneration or other governance matters, business performance or organizational strategy; to influence corporate activities such as mergers or acquisitions, or the use of cash on hand; to unlock value through divestments or other measures; or to remove or appoint directors.

Faced with increasing activism among their stakeholders, many organizations have chosen to respond proactively by heightening their engagement with their most significant shareholders, enabling them to provide input to draft policies and to address concerns in areas where policies have allowed the organization significant discretion. Some of this increased interaction has been driven by, or at least enhanced by, regulatory and quasi-regulatory initiatives such as the European Union’s Shareholder Rights Directive, which is being revised to better facilitate shareholder interaction with organizations. Similarly, the UK Stewardship Code, which is voluntary yet has signatories covering a large portion of the assets under management in the United Kingdom, focuses on strengthening the engagement around long-term strategies to facilitate clear expectations of how organizations and investors can work together to achieve a longer-term increase in the organization’s value.

Organizations that do attempt to better engage their stakeholders may still find themselves questioned by shareholders. Every organization, therefore, needs to be well-prepared and ensure they understand their vulnerabilities and exposures, and be prepared to explain and defend the actions, strategies, and policies that may attract activist shareholders’ attention. Management and the board should also have a clear, fact-based understanding of the organization’s short- and long-term value, including the value of the organization and its component parts under different alternatives and scenarios, which it can use to defend its decisions if they are questioned by activist shareholders.
Questions for directors to ask

- Do we have a ready plan to follow in the event of activist inquiries? Who does the plan cover: management, the board, others?

- How well does management understand the organization’s shareholders’ and other stakeholders’ opinions of the organization and their concerns about it, its strategies, and business activities? How often does management brief the board on its monitoring of shareholder opinion and its outreach to key stakeholders?

- What role does the board play in maintaining an ongoing dialog with the organization’s largest shareholders? What are their primary concerns? Have we, as a board, responded to those concerns appropriately? Have we communicated our response to those stakeholders?

- Do we have a clear understanding of our organization’s greatest vulnerabilities—the decisions and actions we have taken that are most likely to attract the attention of activist shareholders? Are we prepared to defend these decisions with a fact-based assessment of their value?

- Is management monitoring what is happening in our industry and to other organizations that are similar to us in order to determine whether there have been any changes in shareholder or public perceptions about our organization? Does management monitor social media in addition to traditional media to determine what people are saying about our organization? How often is this information shared with the board?

The biggest risk facing organizations and their boards is not listening to and responding to their shareholders and other stakeholders. Conversely, organizations that do open a genuine dialog with their shareholders about the organization and its strategies to create value are much more likely to have the strong support of their shareholders in the event that activists begin targeting the organization.

Tracy Gordon, London

Having a genuine dialog around more than just processes, such as board composition, and sharing an honest and open view with their key investors is important. Today, we’re seeing the most proactive organizations inviting investor feedback into the design of various governance features, such as the remuneration architecture.

Natasha De Soysa, London
A director’s perspective

A conversation with
James L. Goodfellow

What are the big governance issues facing boards today?

There are several key issues, but I believe the board’s engagement with shareholders tops the governance radar screens of many North American public companies.

Traditionally, the board is responsible for approving the organization’s communication and/or disclosure policy, while it delegates the implementation to management. That division of responsibilities is now stressed as shareholders demand greater engagement on business issues, like capital allocation choices, and access to the board on governance issues, like executive compensation. So, I think many boards feel it is time to take a fresh look at shareholder and other stakeholder communications.

At a minimum, organizations must fully comply with their regulatory financial reporting and disclosure requirements. That’s “table stakes” or, to use a sports analogy, it’s playing defense. Today, I think organizations need to go beyond compliance and really engage their shareholders and perhaps other stakeholders. The best not only provide regular, balanced, and meaningful communications, they also establish open communication channels with their shareholders, meet with them, and listen to them. They’ve moved beyond communications to engagement, and are playing offense.

I suggest that boards look at where management has positioned shareholder communications on a continuum, between passive, compliance-focused communications at one end and active shareholder engagement at the other end, and ask: Is that where our major shareholders believe the organization should be positioned? Is it where the board would position the organization? If either or both answers are no, they’ll need to work with management to figure out where they should be and how to get there.

What should a shareholder engagement program look like?

I believe it should have two key objectives. One is to help shareholders understand the performance of the organization, its operating results, long-term strategies, principal business risks, competitive challenges, etc. This is typically management’s responsibility and, in public companies, that’s usually done through an investor relations program.

The second objective should be to engage shareholders in key business performance and governance issues. For example, many public company shareholders are pressing for an increase in total shareholder returns through increased dividends and/or share buybacks. Executive compensation is a global lightning rod for stakeholder concerns in all organizations, especially public companies where there are advisory “say on pay votes” and proxy advisory firms actively stirring the pot. I don’t believe organizations can afford not to proactively engage their shareholders on such matters—though, that does not mean automatically yielding to their demands!

Is it a challenge to understand shareholders’ concerns and information needs?

It is, because a public company’s shareholders are not a homogenous group. One thing the board shouldn’t do is to wait for the next proxy season to see what governance issues are “top of mind” for their shareholders.

Proxy advisors have positioned themselves between companies and their shareholders, and they advise their clients—the company’s shareholders—on how they should vote. This complicates the relationship between companies and shareholders and companies shouldn’t assume the proxy advisors always represent their shareholders’ information needs or views; they need to ascertain those needs directly from the shareholders.

I’d be concerned if a board or company treated the disclosures in the proxy circular as just a legal or regulatory compliance issue. The circular should be viewed as a vehicle to clearly set out the key messages, governance principles and rationale, and the supporting positions taken by the board.

Boards and management also need to agree on their understanding of investors’ concerns and the organization’s response to them. Many boards proactively meet with the proxy advisors and major shareholders to ensure the board’s position and messages on governance issues are being heard and understood.
Are highly dense and technical disclosures drowning out the key messages?

In the early 90s, concerns were raised that the quantity of financial disclosures were so excessive that it diminished the overall value of the disclosures. More recently, in 2008, then U.S. Securities and Exchange Commission (SEC) Chairman Christopher Cox announced a 21st Century Disclosure Initiative, but nothing tangible came of it. In January 2014, the current SEC Chair, Mary Jo White, said that staff was looking at ways companies could avoid repetition in financial reports, or make their disclosures clearer. But a few months later, the SEC appeared to switch gears and said they were now focusing on improving the “effectiveness” of disclosures, which means they’ll also look at situations where additional disclosure may be useful or necessary.

So what has happened since the early 90’s? The volume of disclosures in the financial statements, the MD&A and the proxy circular has grown dramatically—nothing gets eliminated, regulators and standard setters keep adding more—and to what result? Readers are often more confused and confounded than informed and enlightened. Important, relevant, and meaningful information is often hidden and obscured. And it all wastes a lot of time and effort by management and auditors while generating significant costs.

Despite this, I’m encouraged by the UK Financial Reporting Council’s (FRC) recent requirement for boards to produce reports and accounts that are “fair, balanced and understandable.” Even more encouraging, the FRC isn’t issuing a raft of supporting regulations and companion policies to define those terms. As its CEO, Stephen Haddrill, put it: “‘fair, balanced and understandable’ have a common English meaning and we want people to engage and think about how they will apply this.”

How is management likely to react to the board engaging with shareholders?

In some situations, I’m sure management will be anxious—perhaps, very anxious—but I also think management realizes it’s very difficult for them to speak with credibility on governance-related matters. Take executive compensation, for example. Shareholders want to speak to the people who decide the executive compensation, not the people who receive it.

The board chair and the chairs of the compensation committee, governance committee, and audit committee are often front and center with respect to governance engagement activities. Directly involving them in governance-related shareholder engagement gives them a better understanding of the governance concerns of their shareholders, how their governance practices are perceived by the people who elect the directors, and how their governance practices might be improved.

What this means is management and the board need to be on the same page. In a public company, that means the management-directed investor relations programs and board-directed governance engagement activities have to be coordinated and supportive of each other so shareholders don’t receive inconsistent or contradictory information.

You mentioned shareholders’ concerns about capital allocation decisions. Would you elaborate on this?

With today’s low interest rates, long term bond yields aren’t that attractive so shareholders are desperately seeking to enhance the returns on their investments. They want more information on how companies intend to use cash assets and capital and, if they aren’t satisfied, they are demanding that cash assets or capital be allocated to them either through enhanced dividends or share buybacks. Because of this, unprecedented amounts of capital have recently been returned to shareholders in the form of share buybacks.

Consider Apple Inc. In 2014, Apple spent $45 billion in share repurchases, including $17 billion in its fourth quarter that ended in September 2014. Yet in October, an activist investor wrote an open letter to Apple calling for a further acceleration of share repurchases. Apple is probably a unique case, but many companies are feeling this pressure, especially if their stock is perceived to be undervalued, their performance isn’t meeting expectations or they have assets that are not being utilized effectively. How the board and management respond depends on the company’s financial and business circumstances and what they believe is in the best interests of both the company and shareholders. But open lines of communication and engagement can help these parties find an acceptable solution.

What ground rules should be laid out for a shareholder engagement program?

A good shareholder engagement program can help management, boards, and shareholders work together to resolve difficult issues without litigation or getting into proxy fights. To be sure, developing such a program takes time and effort but that shouldn’t stop companies from getting started, since shareholders aren’t likely to stop pressing for greater engagement on what they perceive to be key business and governance issues. But the steps are straightforward. The board and management need to agree on their respective roles in the process, and how they will engage with their various stakeholder groups, including any intermediaries such as proxy advisors. Next, they need to determine the issues they are willing to discuss and those that are off limits. And finally, they should figure out in advance how they will address hot button issues, such as share buybacks and executive compensation, so they aren’t left scrambling when shareholders and other stakeholders begin asking the difficult questions.

What about communications and engagement with other stakeholders?

Many elements of an effective shareholder engagement program can be applied to other stakeholder groups, and probably should, since organizations engage with and create value for many stakeholders all of whom have specific interests in the organization’s strategies and performance. What differentiates shareholders from other stakeholders is that they elect the board, so direct engagement by the board may not be appropriate or practical for other stakeholder groups. Other initiatives, such as integrated reporting, do hold a great deal of promise as a means of satisfying those stakeholder concerns and information needs.
Corporate reporting is an ongoing challenge for boards of directors. Although they do not prepare the organization’s disclosures, they must approve and take ultimate responsibility for them. Those disclosures have grown in volume and complexity in recent years: they must meet the sometimes conflicting or duplicative requirements set out by accounting standards bodies and securities regulators, reflect different reporting standards in different jurisdictions, and do it all while telling the story of the business in a way that is understandable and useful for shareholders and other stakeholders.

If stakeholders can’t find relevant, understandable, and timely information in an organization’s disclosures, it may be because the information they want wasn’t included; many stakeholders, for example, feel organizations provide inadequate non-financial information. When the information they want is provided, it may not be connected; organizations report financial, non-financial, governance, operational, and strategic matters, but typically do so in stand-alone documents that are not well integrated or linked. (Refer to the Sustainability section of this publication for more on integrated reporting.)

Various initiatives have tried to address some of these problems. Continuous auditing and continuous reporting, for example, would enable stakeholders to receive financial and non-financial information almost in real time, rather than after the quarter end, allowing them to take advantage of important moves and events as they happen. On the other hand, a continuous stream of information, at least some of which would likely be immaterial, would only exacerbate the current information overload. Continuous auditing and reporting hasn’t been widely adopted by organizations, likely because of its cost, minimal demand for it by stakeholders, and a fear that continuous disclosure may put the organization at a competitive disadvantage.

Regulators such as the SEC, the UK’s HM Revenues & Customs, and Singapore’s Companies House, among others, require publicly-listed companies to use XBRL (eXtensible Business Reporting Language). The SEC phased-in its requirements for XBRL, based on company size, including phasing-in the amount of information to be provided in XBRL format in the initial and subsequent reporting years. While organizations have met these regulatory requirements, it is still too early to determine if XBRL will bring significant benefits to shareholders. XBRL does allow stakeholders to search an entity’s disclosures for the information they need, but their ability to compare the disclosures of different organizations may be limited if organizations don’t tag and categorize their disclosures in the same way.

A major cause of the “noise” in most organizations’ reporting is the inclusion of immaterial information. “More” has definitely not resulted in “better.” While the primary purpose of corporate disclosures is to attract investors, that objective seems to have become secondary to one of avoiding litigation or regulatory scrutiny. Disclosures are increasingly being directed by legal counsel, who advises disclosing everything with a minimum of detail.

Given this environment, it is not surprising that shareholders and regulators are concerned about the amount of boilerplate content and lack of transparency in many organizations’ disclosures. Regulatory bodies, such as the IASB, the U.S. FASB, the UK FRC, and the SEC, are all looking at ways to reduce excessive disclosures and improve the quality of information. While some proposals and exposure drafts have been issued, such as the FASB’s Proposed Statement of Financial Accounting Concepts, many of these initiatives are longer-term efforts.

In May 2014, the Center for Audit Quality (CAQ) and the Institute for Corporate Responsibility (ICR) at the George Washington University School of Business launched an initiative on Rethinking Financial Disclosure. In November, the initiative presented its report to the SEC. It contains 11 recommendations for improving the effectiveness of disclosures, including:

- Providing executive summaries that highlight only the changes made compared to the previous year’s submission
- Stratifying risk factors according to non-company-specific and company-specific issues
- Requiring a “Strategic Report” that illuminates the company’s objectives and strategies, and
- Creating a “Muse Project” to solicit crowd sourcing ideas on better ways to disclose information, particularly as related to reporting on risks.

If an organization is to disclose information that is useful to its stakeholders, it must first understand what each stakeholder group values, and the value the organization either gains or loses from the way it is perceived. Transparent, useful disclosures can do more than just attract investors; they can also help win the support of other stakeholders, including employees, customers, and others, by demonstrating the organization’s commitment to and performance in areas of importance to them.

The updated 2013 COSO Framework replaces the former 1992 COSO Framework for attestation reports issued after December 15, 2014. While management should have transitioned the organization to the new framework, directors—and audit committee members in particular—should be sure they understand their responsibilities under COSO 2013. The 2013 framework defines 17 principles of internal control and increases the level of rigor required to evaluate the design and effectiveness of internal control. All 17 principles must be present and functioning in order to conclude that internal control over financial reporting is effective.

The new framework emphasizes the board’s role in creating an effective control environment and having a robust risk assessment process, including identifying and addressing fraud risks. In particular, the board is responsible for:

- Providing clarity regarding expectations for integrity and ethics, conflicts of interest, adherence to codes of conduct, and other matters
- Assessing the risk of management override of internal control and the possibility that management may override those controls, and
- Establishing and maintaining open lines of communication between management and the board, and the provision of separate lines of communication, such as whistleblower hotlines.

Questions for directors to ask

○ What feedback have we received from shareholders, regulators, and other stakeholders regarding our organization’s disclosures? Did they have suggestions for improvement? Have we followed up on those suggestions?

○ What steps have we taken to make our disclosures more accessible for our stakeholders? Do we make use of websites or other technologies to improve interactivity, so shareholders can more easily identify the information they need in our disclosures? What is our experience with XBRL? Is simply meeting the XBRL requirements enough? Have we considered how going beyond those requirements might affect our organization and its relationships with its key shareholders?

○ Have we reviewed the disclosures of organizations similar to ours to determine how ours compare? Do we review best practice disclosures to identify ways we can improve ours?

○ What are our primary considerations when we are asked to approve our organization’s disclosures? Do we disclose immaterial information rather than risk not being compliant with the regulatory requirements? Do we rely on legal opinions to guide the language we use? Do we review our disclosures from the perspective of an investor?

○ Have we considered ways to adapt the format of our disclosures so they tell a clearer story about our organization?

○ How closely are we monitoring regulatory developments aimed at improving the transparency and usefulness of disclosure information? Have we considered how the proposed measures might affect our disclosures?

Directors aren’t necessarily experts on regulatory requirements, and they can’t spend as much time on the business or the disclosures requirements as management, yet they are still responsible for the story that gets told through the disclosures. Trying to ensure that the story is told clearly, while also complying with all of the regulatory requirements, is one of the biggest challenges facing directors in terms of corporate reporting.

Al Donald, Toronto

Reporting requirements for publicly listed companies are set by different bodies—the accounting standards boards and the capital market regulators. Their rules are written from different perspectives, sometimes duplicative, and organizations can be overwhelmed by the amount of information they’re required to disclose. While they have to meet the regulatory requirements, they also need to tell a clear story for their shareholders and stakeholders, and doing both isn’t easy.”

Stacey Nagle, Toronto
A generation ago, most of the corporate value in the S&P 500 was in tangible assets—80 percent in 1975, with intangible assets comprising less than 20 percent of market capitalization. Today, that ratio has been inverted—nearly 80 percent of corporate value is found in intangible assets. This change reflects the transition from a manufacturing-based economy to one that is service/knowledge-based, something that accounting standards and traditional metrics have not kept pace with and, as a result, soft assets, such as expertise, synergies, innovation or customer base, have not been well measured.

Investors and other stakeholders clearly recognize that an organization’s value is no longer created solely within its walls. Organizations have numerous value drivers, many of them intangible, and the value of an organization can be affected, both positively and negatively, by events and processes that occur outside the organization and outside its local geography. For example, changes in an organization’s environment, such as demographic changes, resource or energy limitations, new technological developments, and other factors, can dramatically change its business model—either disrupting or enhancing it—thereby changing the value of the organization.

Because of this, stakeholders want to understand where and how the organization’s value is created, and they’re pushing organizations for better disclosures of non-financial information. Organizations are feeling that pressure, which has resulted in a dramatic increase in the number of companies reporting on their sustainability performance. In 2013, 72 percent of the S&P 500 companies reported on environmental, social, and governance (ESG) performance, up from just 53 percent that did so a year earlier. Organizations that reported on sustainability saw positive effects on their reputation and valuation compared to organizations that did not report their ESG performance, and those that reported using the Global Reporting Initiative (GRI) framework enjoyed the greatest benefits.14

Ultimately, what shareholders would like is for organizations to provide an Integrated Report <IR>. Many organizations have started providing a sustainability report as the first step on their journey towards integrated reporting. Typically, it takes a few years to refine sustainability reporting; initially, companies disclose information on matters about which they have available data or can report positive results. In the second or third year, they have refined their concept of materiality and determined what is important to their stakeholders and their business, which often means moving from more obvious sustainability indicators to those that are most relevant to their organization.

For their part, investors and other stakeholders have also become sophisticated in their understanding of sustainability disclosures. They know the indicators that are relevant and will question organizations that do not report on those indicators. Organizations whose reporting of non-financial information is considered to be inadequate may find themselves with low ESG scores compared to their peers, and may possibly be targeted through social media or by other external parties.

Despite its name, integrated reporting isn’t just a reporting exercise. Because integrated reporting identifies and measures all of the attributes that create value for the organization, it helps organizations to manage their business in a more holistic way, enabling management to utilize all of the various financial and non-financial capitals more effectively.

In June 2014, the Natural Capital Coalition (NCC) announced that the World Business Council for Sustainability (WBCSD) and the International Union for Conservation of Nature (IUCN) will develop a Natural Capital Protocol to provide a standardized global methodology to help organizations understand their impacts and dependence on natural assets including ecosystem services. This initiative will solidify the business case for sustainability and integrated reporting.

Globally, regulators appear to be slowly moving towards integrated reporting. In South Africa, publicly listed companies are required to comply with the King III Report, which deals with integrated reporting; they must either comply with or explain why they have chosen not to apply the principles. Most listed companies in South Africa do produce integrated reports. Brazil requires listed entities to produce either a sustainability report or an integrated report to disclose non-financial information. Malaysia is considering including an integrated reporting requirement in its accounting standards, but it is not yet mandatory.

The International Integrated Reporting Council (IIRC) has announced initiatives designed to add value to integrated reports. Currently, auditing standards can be applied to some sections of an integrated report, but there is no formalized assurance standard specifically for integrated reporting. As a first step towards developing a formal standard, the IIRC has released a discussion paper on the assurance of integrated reports. In November 2014, the IIRC launched an <IR>-Technology Initiative to determine how technology can be used to facilitate the production, related management processes, and assurance of an integrated report. The project’s objective is to “evaluate how technology is currently used to facilitate corporate reporting and related management processes, how technology might enhance integrated thinking, how software can capture narrative elements of reporting, and how technology can facilitate the audit and assurance of an integrated report.”16

Boards of directors are increasingly playing a role in integrated reporting. Initially, many boards were uncertain of the oversight they should apply to integrated reporting and what should be included. Today they have greater clarity around their role since the IIRC framework sets out a structure for an integrated report, including the principles underlying the report and the various content elements to be covered in the report. Although the IIRC framework is voluntary, it has been adopted by many organizations that provide integrated reports.

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13 Ocean Tomo 300® Patent Index.
Questions for directors to ask

- Does our organization provide either a sustainability report or an integrated report? If not, can we afford to be an organization that does not provide such reports to our stakeholders?
- If we do provide a sustainability report or an integrated report, do we follow the GRI framework or the IIRC framework? Are we sure that we are providing information on the indicators that truly matter to our organization and which are material in creating value? Are there areas where we can improve our reporting?
- What feedback have we received from investors, analysts, key shareholders, and others about our reporting? Are they generally satisfied with the quality? Do we monitor social media to learn what is being said about our organization and its reporting?
- What impact has integrated reporting had on enabling our organization to better understand and manage not only its financial assets but also all of its non-financial capitals? Are we seeing benefits in this area? If not, why not?

Organizations that take sustainability and integrated reporting seriously, and invest the time and capital in the reporting process, can enjoy a huge competitive advantage since an integrated report informs stakeholders about the organization and how it creates value. When stakeholders understand that, it can create opportunities for the organization.

Claire Hoy, Cape Town

Integrated reporting focuses on the way in which the organization is managed and the way in which all of its various capitals and resources are utilized to deliver value. It presents that picture in an integrated way, which not only benefits stakeholders, but also benefits management and the board in helping them better manage the organization.

Johan Erasmus, Johannesburg
Eyes on the board

The articles in this publication highlight some of the top issues facing boards of directors in 2015. Each board will likely have additional priorities related to its own circumstances and the particular issues facing its organization.

One overriding concern for boards as they address the issues discussed in this publication will be the continued volatility of the global economy, where regional and even local events increasingly have global impacts. While the U.S. economy is growing and the value of the U.S. dollar is increasing, the European economy remains weak and Asian markets are slowing as their exports decline. Oil prices fell quickly at the end of 2014 and are now at their lowest level in years, something that will benefit some organizations and markets while creating challenges for others. Geopolitical tensions, terrorist activities, cyber threats, and health risks, such as Ebola, all have the potential to significantly disrupt organizations and markets, while digital disruption continues to dramatically change many industries and organizations.

In this environment, the most successful organizations will be the ones with a well-defined strategy, supported by a strong risk management program. Organizations will also need to ensure they engage their stakeholders, to ensure they understand and support the organization’s investment decisions and other initiatives. And since every organization may suddenly encounter an unexpected negative event, boards and management must operate with integrity to help protect themselves and their organizations from reputational damage.

Some boards may also need a different mix of collective expertise and knowledge if they are to successfully understand, address, and respond to all of the issues facing their organization. Many will also need to become more diverse. Boards need directors with differing cultural backgrounds, genders, and ages to not only reflect the diversity of the organization’s stakeholders—especially at a time when boards are under greater public scrutiny—but also to bring wider points of view to boardroom discussions.

While board education programs have always been important, they are particularly so at a time when directors need to quickly get up to speed with complex new issues, and keep their knowledge up to date as those issues evolve. As they discuss complex matters, boards should also seek the advice of subject matter experts, both from within and outside the organization.

We hope this publication will help your board succeed in 2015 and serve as a catalyst for your boardroom discussions. Contact your Deloitte governance leader to continue the conversation.
Resources

Visit our Center for Corporate Governance to find relevant resources to support your board’s needs.

**Strategy**
- A telling performance: Surveying narrative reporting in annual reports (Deloitte UK)
- Aligning Compliance Responsibilities with Business Priorities (Deloitte U.S.)
- CFO Insights: The Strategist CFO: Four orientations for engaging in the strategy process (Deloitte U.S.)
- From follower to leader (Deloitte U.S.)
- Going from good to great (Deloitte U.S.)
- Performance management is broken (Deloitte U.S.)
- Relatively Right vs. Wholly Wrong: Weekend Reading (Deloitte U.S.)

**Reputation**
- 2014 global survey on reputation risk (DTTL)

**Subsidiary governance**
- Governance of Subsidiaries: A survey of global companies (Deloitte India)
- Supply Unchained – Fighting Labor Abuse in Your Supply Chain: Weekend Reading (Deloitte U.S.)

**Board composition**
- 2014 Board Practices Report: Perspectives from the boardroom (Deloitte U.S. and Society of Corporate Secretaries and Governance Professionals)
- Deloitte 360: Growth from all directions (DTTL)
- New Board Dynamics: Composition, roles, responsibilities of the board under the Companies Act, 2013 (Deloitte India)

**Regulation**
- Deloitte regulatory news alert: Disclosure of non-financial and diversity information - get ready (Deloitte Luxembourg)
- Enterprise compliance: The Risk Intelligent approach (Deloitte U.S.)
- Evolving in response to global re-regulation (Deloitte Canada)
- Seizing the regulatory opportunity (Deloitte Canada)
- Top 10 for 2014: Our Outlook for Financial Markets Regulation and Supervision (Deloitte UK)
Technology
Audit Committee Brief: Technology at the forefront (Deloitte U.S.)
Audit Committees: The Risks and Rewards of Emerging Technologies (Deloitte U.S.)
Cyber security: Everybody’s imperative (Deloitte Canada)
Deloitte on Disruption (Deloitte U.S.)
Digital disruption – Harnessing the ‘bang’ (Deloitte Australia)
Embracing Digital: Why Boards That Don’t Could Put Companies at Risk (Deloitte U.S.)
Inside magazine – Issue 6 for CIOs (Deloitte Luxembourg)
Tech Trends 2014 (Deloitte U.S.)
TMT Predictions 2014 (DTTL)

Organizational talent
Global Human Capital Trends 2014 (Deloitte U.S.)
Talent Edge 2020: Redrafting Strategies for the Uneven Recovery (Deloitte U.S.)
What if the road to inclusion were really an intersection? (Deloitte U.S.)

Activism
Shareholder Activism: Managing Independent-Minded Investors (Deloitte U.S.)
Three Leading Practices to Help Address Shareholder Activism (Deloitte U.S.)

Corporate reporting
Is more less? Exploring a new world of corporate reporting (Deloitte Canada)
The new International Integrated Reporting Framework: A review guide for Audit Committee members (Deloitte South Africa)

Sustainability
Simplifying complexity: The 8 Sustainability Challenges for Canadian Business in 2014 (Deloitte Canada)
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Our corporate governance leaders around the world are available to discuss the issues raised in this publication or any questions that are of interest to your board.
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