Dear readers,

Disruption has become the norm in our volatile global business environment. This disruption is accelerated by a variety of factors—new technologies, cultural changes, demographic trends, geopolitical events, and globalization—that often work in tandem.

These factors have the potential to seriously disrupt current business models. Organizations that choose to embrace this disruption rather than taking a strictly defensive posture are those best positioned to generate long-term value for their stakeholders. This requires the ability to anticipate disruptive events and a willingness to respond to them courageously while focusing on long-term success. Leaders will need to find ways to seize the initiative and leverage disruption to their advantage.

This edition of Deloitte’s Directors’ Alert examines some of the opportunities and challenges likely to face boards of directors in 2017. Many of these are ongoing issues: the need to develop and execute an effective long-term strategy in a disruptive environment; the war for talent and the advantages of a corporate culture aligned to the organization’s strategic vision; greater scrutiny of executive compensation by shareholders and the media; and the benefits of boardroom diversity that is based not only on gender, race, and age, but also on the experience and problem-solving approaches of the directors. In addition, organizations will also face unique challenges that reflect their own particular circumstances.

Several of our global business leaders were interviewed for this edition; these individuals work closely with many of the world’s leading organizations and they are often sought at major industry events to provide perspectives on the issues boards are likely to encounter in 2017. These leaders offer their insights to help directors focus on what matters so they can work with management to develop appropriate action plans to capitalize on the disruptive opportunities and to mitigate their associated risks.

We also spoke with directors of leading global organizations from different regions to gain their views of the challenges and opportunities for boards in 2017. They provide provocative insights into the role of the board, including the growing demands being placed on directors and the need to devote sufficient time to the activities that create value for their organizations. They express concerns about the impact of the global regulatory environment on their businesses and the wider economy, as well as the need for prudent disclosures that provide insights into board decisions and business operations without compromising competitive position.

Each article provides a list of questions directors can ask to begin exploring the issues with their own boards. These questions are not exhaustive, but provide a framework so directors can ask their own questions and continue the discussion until they are comfortable that management is well positioned to address the issues. We also provide tools and resources to help directors dig deeper; these can be downloaded from our website or obtained by contacting your Deloitte partner.

Dan Konigsburg
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One of executive management’s central responsibilities is the design and timely execution of strategy. For directors, it is to challenge, vet, and ultimately ratify that strategy.

Yet in this ever more dynamic, uncertain, and disruption-filled environment, many argue that strategy is too hard to do, of secondary importance, or, worse, irrelevant. A sure sign of this abdication is the rise of strategy as slogan: “Our strategy is to be flexible,” or “agile,” or “digital.”

But the need to make a coherent set of choices, which is the centerpiece of strategy, has never been more important. At its core, strategy is the basis on which to direct a company’s precious resources. It is the connective tissue across layers of management and between functions. It serves as the filter to distinguish opportunities from the many distractions posed by a changing environment. Good strategy, executed well, is essential to strong financial performance and the creation of lasting value over time. Good strategy, articulated convincingly, is essential in communicating with stakeholders and capital markets, and enhancing transparency in an age of rising shareholder activism and social media storms. And good strategy, framed carefully, should enable the transformations organizations must undergo not just to survive, but to thrive in the future.

This raises an obvious question: what does it take to produce great strategy in a cyclonic environment? Processes, methodologies, and capabilities of a sort are all necessary, but they are not sufficient. Nor are innovations in customer research, data analytics, and fast-cycle prototyping despite the fact that they are all advancing strategy.

What really differentiates strategy is courage.

Courage is the willingness to take action when it is hard, or risky, or scary to do so. In the tighter context of business strategy, it’s the willingness to engage in courageous conversations, to spark courageous considerations, and to make and execute courageous choices.

**Courageous conversations**

Open dialogue is the engine of executive commitment. So yes, discussions on strategy among executives, between executives and the board, and throughout the organization should be purposeful; they should be structured and appropriately focused or expansive depending on the situation and topic.

And they should be courageous. A courageous conversation is one that deals with difficult or uncomfortable topics not marginally, but deliberately and centrally. It is one that not only involves, but invites a diversity of perspectives. Executives and board members who promote courageous conversations recognize that questions are an asset to be deployed wisely and kindly, not liberally and haphazardly. And conversely, a courageous conversation is one that invites participants to not only ask questions, but to question answers, especially at a time today of massive disruption and prolonged uncertainty.

Injecting courage into strategy
Courageous considerations
Across industries, long-standing conventions about boundaries, the durability of advantages, and ways to compete are changing fast; the outcomes, the near- and mid-term destinations, uncertain. With this kind of institutionalized discomfort, it’s easy for senior executives and board members to try to hold on to what they know, including their traditional assumptions about their businesses and the world around them.

But certainty is an illusion. In the current environment, creating and sustaining a sound strategy requires a willingness to deal with the realities of a tumultuous marketplace, changing customer needs or boundary-busting competitors—no matter how hard, or unappealing, or counter-intuitive it may be to do so. An effective strategy requires confronting uncertainty rather than denying its existence or being paralyzed by it. It means thinking broadly about how fundamentally different the environment might be in three, five or 10 years from now—powered by globalization, changing demographics, and exponential leaps in technology, connectivity, and digitization. It means the willingness to consider very different possibilities by which to position, design new value for customers, compete, and collaborate over time.

Courageous choices
Ultimately, good strategy design requires executives, with the support of their boards, to translate consideration, examination, dialogue, and experimentation into meaningful and actionable choices. Courageous choices mean making real trade-offs: choosing to participate in some markets and not others; choosing to serve and delight certain customers and dissuading or not serving others; choosing to invest in specific and defensible sources of advantage, not in any and all possible capabilities.

By extension, courageous choices involve the willingness to stop funding businesses or initiatives that made sense at one point in time but do not, or may not, anymore, in order to prudently, yet purposely, invest in the positions, innovations, and experiments that will expose or define the future. Success requires the courage to overcome the tendency to systematically underestimate the risk of the status quo while overestimating the risk of doing something new or different. By making and acting on courageous choices, executives and boards can shape a corporate portfolio to win in the future rather than simply protect the past.

“At this time of uncertainty and disruption, strategy design and execution have never been more important. The challenge is not simply to spend time on strategy, but to truly inject courage into strategy—by engaging in courageous conversations, sparking courageous considerations, and ultimately making and acting upon courageous choices.”

Jonathan Goodman
Strategy design and execution should not be comfortable. It takes courage on the part of both executives and boards to confront a changing marketplace, engage in more inclusive conversations, and weigh benefits and risks in the face of uncertainty.

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<th>Questions for directors to ask</th>
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<td>• What are the core assumptions that underpin our current strategy? Do these assumptions still hold given the dynamics of our marketplace, customers, competitors, or emergent ecosystems?</td>
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<td>• What types of disruptions are we likely to face? What threats or opportunities do these disruptions pose? Are we being sufficiently bold with our innovation activities?</td>
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<td>• Are we in the right businesses? Are we the best owner for our businesses? What business models should we adopt to create value in the future?</td>
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<td>• Does our strategy involve genuine trade-offs? What are we choosing not to do? Where are we choosing not to invest, and why?</td>
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<td>• Do we have the leadership, capabilities, and investment capacity to achieve our objectives? How can we build or access the capabilities required to succeed in the future (e.g., organically or through acquisitions and partnerships)?</td>
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<td>• Do we have enough engagement with executive management on issues of strategy throughout the year?</td>
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<td>• Do we have sufficiently diverse perspectives among executives and board members to develop and execute a winning strategy, one that is tuned to the future as opposed to rooted in the past?</td>
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Organizations have traditionally devoted considerable time and effort to developing sophisticated strategies to capitalize on market opportunities and mitigate market risk, but they’ve tended to pay less attention to the organization’s culture, which can be difficult to measure and manage and was often left to evolve on its own.

That’s not to say that culture hasn’t long been recognized as important. For example, in the 1980s, books such as *In Search of Excellence* by Robert H. Waterman Jr. and Tom Peters took an in-depth look at the influence culture has on strategy.

Today, there is a renewed recognition of the importance of culture in driving strategy. A full 87 percent of CEOs and human resource leaders who responded to Deloitte’s 2016 *Human Capital Trends* survey believe that “culture is a potential competitive advantage.” Just 19 percent believe their organizations have the “right culture,” while more than half indicate that their companies are attempting to change the culture in response to shifting talent markets and increased competition. Only 28 percent believe they truly understand their culture.

**Aligning strategy and culture**

A recent study published by the UK Financial Reporting Council concluded that, “The strategy to achieve a company’s purpose should reflect the values and culture of the company and should not be developed in isolation. Boards should oversee both.”

Culture can be thought of as “the way we do things here,” and includes the values, beliefs, behaviors, artifacts, and reward systems that influence people’s day-to-day behavior. Culture has a pervasive impact on the organization because it defines the way employees serve customers and interact with each other, and the way they and the organization respond to challenges.

Culture is particularly important to today’s workforce. The Millennial generation places considerable value on work/life balance, the organization’s purpose, and whether the company is aligned with their personal values and ideas. With the advent of social media, an organization’s culture is no longer confined by its own four walls. Today, Millennials discuss their employers, rate their CEOs, and talk to each other online about their work experience. If the employee proposition is inconsistent with what people are saying about it online, that discrepancy will be exposed quickly.

The importance of culture is perhaps most apparent when things go wrong. A misalignment between culture and strategy may not only reduce the organization’s ability to achieve its strategic objectives, but derail the strategy altogether and significantly damage the organization’s reputation. The 2008 financial crisis highlighted the impact of culture on strategy; had cultural behaviors been different at many financial services companies, the financial disruption may have been mitigated.

Culture needs to be a top concern of boards of directors and of management for two reasons. First, the consequences of misaligned strategy and behavior will affect all aspects of the organization. Second, the cultural tone of the organization needs to be set from the top; if it isn’t, a strong culture aligned with the organization’s objectives won’t evolve on its own.
An organization’s culture cannot change overnight. Creating a sustainable culture also requires employee stability; organizations with high employee turnover tend to have weaker cultures, and that may be exacerbated by extended talent models that include contractors and other outside workers who are not on the organization’s payroll.

On the other hand, as the Millennials become the largest demographic group in most organizations, their new perspectives and values provide organizations with an opportunity to refresh their culture.

**Tone at the top**
Because culture has a pervasive impact, it can’t be delegated to the human resources department; it must be a critical responsibility of the board and management.

The organization’s leaders—its board of directors and senior management—need to set the tone at the top, establishing a model for the behavior expected of all employees. Leaders must also be aware of the way culture cascades throughout the organization. A well-intentioned tone at the top will become disrupted if an employee’s immediate supervisor sets a different example and rewards different priorities.

It’s important for leaders to understand the culture of their organization and its strategic limitations. Most current talent surveys measure employees’ engagement and how they feel about “the way things work,” but they don’t identify the underlying reasons that drive those evaluations. To assess the cultural climate and determine whether it enables or hinders the underlying strategy, organizations need to go beyond multiple-choice surveys. An alternative is to run periodic business-case simulations to see how people react to different circumstances, such as the stress involved in meeting performance measures, pressure from a colleague to participate in unethical activities, opportunities to circumvent controls, or the need to reassure unhappy customers. Sessions like these can help identify potentially risky behaviors that need to be addressed.

Finally, despite an increasing awareness of the importance of culture, few organizations discuss it in their annual reports. As organizations gain a deeper awareness of the power of corporate culture to help or hinder strategic and financial objectives, they may want to consider the benefits of greater disclosure.

**Measuring culture**
Recent research by Deloitte has identified both core and differentiated measures of culture.

**Central core indices**
- **Collective focus.** How much does the organization emphasize collaboration and teaming over individual initiative?
- **Risk and governance.** How important is compliance and how much structure is provided with respect to behavior? In some organizations, this is a continuum where levels of structure differ from one business unit to another.
- **External orientation.** How much energy is put into serving customers and dealing with the outside environment compared to the time and effort spent on internal dynamics?
- **Change and innovation.** How important is it for the organization to pursue new directions and opportunities?

**Differentiated indices**
- **Courage.** Do people have the courage to confront ethical dilemmas or failures?
- **Inclusion.** How accepting is the organization of people with different ideas and backgrounds?
- **Commitment.** What is the level of employee commitment and engagement? Do they feel a sense of pride and ownership in the organization?
- **Shared beliefs.** What specific values and beliefs are important to the organization?
Questions for directors to ask

- How well do we understand the culture of our organization? Have we tried to measure it and, if so, do we track progress to see how our culture may be changing?

- What are our employees and others saying about our organization on social media and elsewhere? How well does that match our own understanding of who we are and what we value?

- If we’ve undertaken a major merger or acquisition, do we understand its impact on our culture? What are we doing to prevent our culture from being adversely affected?

- Is culture considered in how we evaluate and reward the CEO? Do our leadership succession strategies include culture and ethics as criteria when selecting a CEO?

- Do we understand the impact our organization’s culture has on its employment brand and ability to attract, hire, and retain top talent?

- Do we clearly understand the specific behaviors we’re promoting through our performance evaluations and rewards? Do we understand and track how those incentives may influence how our people interact with customers and suppliers? Are we at risk of encouraging unethical behavior by setting objectives that are too aggressive and short-sighted?

“Culture needs to be linked to the daily behaviors of everyone in the organization. The way employees interact with each other and customers, the behaviors the organization rewards, and the example set by its leadership all have an impact on culture, which, in turn, affects the organization’s ability to achieve its strategic objectives.”

Veronica Melian
Courage under fire: Embracing disruption | A director’s perspective

A conversation with Richard H. Lenny

Companies face a growing array of risks—strategic, cyber, reputational, and financial in addition to the risk of disruption. Many are confident that they can oversee the risks they know, but are concerned about the unknown, “black swan” risks that may lie ahead. Companies and their boards are looking to innovation and technology to continue to transform their businesses for future growth. Discussions in the boardroom need to balance between traditional and emerging topics, and devote time for deeper dives into emerging issues that will enable them to better understand the full spectrum of risks and uncertainty facing their organizations.

To gain a director’s perspective on this governance environment, we spoke with Rick Lenny, who shares his thoughts on the role of the board, the challenges created by geopolitical events and emerging innovative technologies, and some of the tough choices that boards need the courage to address.

Richard H. Lenny is the non-executive chairman of Information Resources and a member of the boards of directors of McDonald’s, Discover Financial Services, ConAgra Foods, and Illinois Tool Works. From 2001 through 2007, he was chairman, president, and chief executive officer of The Hershey Company. Earlier in his career, Mr. Lenny was president of the Nabisco Biscuit Company and of Pillsbury, North America.

With the growing demands on boards of directors, where should they focus their attention?
The board’s number one priority should be to deliver superior shareholder value over the long term. Directors are elected by the shareholders and, as fiduciaries of the company, this is what investors expect of the board and it’s the reason they invest in a company.

What can make this a challenge is the ongoing tug of war between focusing on growth and the increasing demands in the name of “better governance.” Obviously, boards must practice good governance; this is nonnegotiable. Practicing good governance is necessary, but this alone is insufficient to deliver superior shareholder value. With so many issues facing the board, boards must avoid the pitfalls of responding to the latest headline and maintain their focus on the critical issues and opportunities facing their companies.

Given this situation, do we need a new governance model?
No. However, I do believe that strong discipline and leadership are required by the board chair, the CEO, and, if the chair and CEO positions are combined, by the lead director to ensure that the board spends the right amount of time on the right topics. This is more than just having the right topics on the agenda; it’s also having these topics addressed at the right level of depth.

Entrusting greater responsibility to the board’s committees is one way to avoid overloading the board’s agenda. A deep dive on the key issues facing the board can oftentimes be more appropriately handled at the committee level. Committees consist of people who are best positioned to address these topics, have access to the appropriate company resources, and can devote the necessary time. Given the calls for greater transparency and disclosure, revising the committees’ charters to reflect these additional responsibilities is a good example of appropriate disclosure.

Are Brexit and other geopolitical issues creating headaches for boards?
You’ve hit on a very difficult and vexing issue. In the best of times, the crystal balls of management and the board are quite cloudy, and when it comes to trying to navigate the unnavigable waters of geopolitical issues, these crystal balls become opaque.

Certain events are beyond a board’s control; as such, a board is ill advised to spend too much time on them. Yes, there are ways to better understand the potential implications of these issues, but immediately altering a company’s strategy isn’t one of them.
An organization has to understand the markets in which it competes and its relative sources of competitive advantage, and then develop and execute a strategy that has the greatest opportunity to deliver superior shareholder value. There should always be contingency plans. While trying to address global issues at the board level might make for an interesting discussion, it’s doubtful that this discussion would provide meaningful insight and benefit to management.

There are continuing calls for greater diversity on boards. What do you think boards will look like five years from now?
It’s imperative that board diversity must improve both in terms of representation and in terms of diversity of experience and of thought. By the very nature of business, and the people moving into leadership positions and starting to populate boards, in five years’ time we’ll see boards that are much more diverse in both areas.

Representation on the board is the “mechanics” of diversity. It’s easy to take the skills matrix, check the boxes, and conclude that the board’s work is done. For example, there’s a risk when boards recruit someone who excels in a particular area just to fill a gap. When this topic comes up, all eyes turn to the expert, but when any other topic comes up, all eyes turn away from that person.

What’s far more important when building a board is creating the right dynamic and the ability of the directors to work well together, particularly in challenging times. The board needs to represent a great diversity of thought, be able to disagree without being disagreeable, and have the appropriate balance of skills and capabilities to address all of the issues with which it contends.

The push for greater disclosures continues. How are boards responding?
There is a misguided belief that the more one asks for, the better one will understand things. More disclosures aren't better; better disclosures are better. Disclosure and transparency are also in the eye of the person asking for it; often when you give people what they asked for they’ll still say it isn’t enough.

This entire issue requires great discipline on the part of organizations and their boards. Boards are being pushed to disclose more, but they can’t do this in any way that might jeopardize the organization’s competitive position. So when boards and management push back regarding more disclosures, it’s not because they are anti-disclosure; it’s because they are concerned about providing some competitive insights that others would be very keen to better understand.

One solution, while being mindful about fair disclosure, is for the board, management, or the lead outside directors to meet with institutional shareholders to discuss what the organization is doing and why. This type of dialogue between the company and its investors is better than trying to cover every request for greater transparency in a document.

What are the tough issues that directors need courage to address?
There are a couple of them. One is the company’s capital structure and choices around capital structure, particularly given the influence and impact of activists. And by the way, boards need to determine how and when to defend the company against activists. They also need to know when to work with activists because it goes both ways; it never hurts to listen and there are times when it makes sense to have the right level of discussions and engagement.
To your question, boards need to make tough decisions around capital structure, major mergers and acquisitions, succession planning, board composition, and turnover—these are tough issues that directors need to confront and have the leadership and courage to want to confront them.

Executive compensation is another tough issue that is front and center. It makes for great headlines, but if a company has a pay-for-performance philosophy—and most companies espouse one—then it must also have pay for performance in practice. This means that when the shareholders do very well, management should get paid, and proxy disclosures notwithstanding, this takes courage.

Given the accelerating pace of disruption in the market, do directors have a solid enough understanding of these threats?

If the board’s number one role is to enable and encourage management to pursue a growth agenda and deliver superior shareholder value over the long term, then the board must have a keen understanding of the markets in which the company competes, its competitive position within these markets, and whether the right executives are in the right roles for the company to succeed.

Simply asking what might disrupt our business will result in a lot of discussion, but usually produces very little insight. A better approach, and one more boards are adopting, is to spend much more time on strategic planning, succession planning, and talent management, all of which are key to remaining relevant. For example, strategic planning used to be a once-a-year exercise; boards would review and approve the annual strategic plan and one of its key responsibilities would be satisfied.

Having management provide an update at various board sessions on one of the key strategic issues ensures that the strategic plan is no longer a once-and-done exercise. A strategic plan needs to be a living vehicle so that the board maintains a strong market-oriented focus. While this approach won’t necessarily identify all of the disruptors, the more the organization and management focus externally, the greater the likelihood that they will have an insight into what could potentially become a disruptor.

Looking ahead, what do you expect will be the major issues facing boards?

There are plenty of issues, but back to our discussion of geopolitical issues, boards need to remain focused on what they can control and where they have influence and impact. So with this in mind, I think boards need to focus on who sits on the board in terms of their qualifications, skills, and ability to work well together as a team, as opposed to nominating someone who might look good in the proxy or will satisfy special interest groups.

Another key issue: does the company have the right leadership team that it needs both now and in the future and is our succession planning process rigorous enough to answer these questions?

Markets are and always will be dynamic. As a board, do we understand what it takes to deliver both superior marketplace and financial performance over the long term? Sometimes boards lean too much in one direction, but winning in the marketplace and winning from a financial standpoint go hand in hand. As we look ahead, boards represent shareholders; as I said at the outset, the commitment to delivering superior shareholder value must always be the board’s number one goal.
“With so many issues facing the board, boards must avoid the pitfalls of responding to the latest headline and maintain their focus on the critical issues and opportunities facing their companies.”

Richard H. Lenny
Regardless of its industry, every organization is now a technology company. That’s the opinion of 67 percent of CEOs surveyed by Fortune magazine in June 2015. Three-quarters of them said cloud computing, mobile computing, and the Internet will be either “very important” or “extremely important” to their businesses in the future. More than 50 percent also said artificial intelligence and machine learning will either be “very important” or “extremely important” to their businesses.

Digital technologies are changing the way organizations operate and are redefining the way they interact with employees, customers, suppliers, and other stakeholders. But digitization also creates new challenges and risks. In fact, CEOs ranked technology-related issues—the rapid pace of technological change (65 percent) and cybersecurity (58 percent)—as two of the top three challenges facing their organizations. Increased regulation, identified by 69 percent of CEOs, was seen as the top challenge.

That misalignment can be serious because most organizations no longer rely on salespeople and other relationship managers to meet with prospective customers, explain the organization’s products and services, and generate new business. Increasingly, organizations interact with their customers and generate sales through their e-commerce platforms, social media, and other Web-based tools.

Used properly, technology can enable businesses to create a strong digital connection with their customers, because those who use a service or website often begin by creating a profile on the site. The information customers upload to a website is hugely valuable, provided the organization also invests in people who understand how to leverage that data.

Technology also presents challenges. For example, under the European Union’s new General Data Protection Regulation and similar requirements in

Realigning the organization in a digital world
other jurisdictions, organizations must protect their customers’ information securely to prevent it from falling into the hands of other parties, and the people who manage that information need to know how to deal with it and with digital channels.

Because most organizations use the same technologies and social media platforms for their digital channels, it may be difficult to distinguish themselves from their competitors. Organizations that want to present a unique value proposition need to figure out how to convey that in an online world.

**Increased vulnerability**

The greater reliance on technology leaves businesses highly vulnerable to disruptions in that technology. An equipment malfunction at a major US air carrier in August 2016 led to a power failure that left tens of thousands of passengers stranded when thousands of flights were cancelled.

Once, when an organization experienced a power failure, it could return to manual processes to keep at least some of its operations moving. Today, technology has become so pervasive that many organizations don’t have manual processes to fall back on, and with the interconnection of technologies, a failure at one organization could have an almost instantaneous ripple effect, causing disruptions at others.

Today, every organization is at risk of a major technology crisis if its critical infrastructure falls victim to a cyber attack, the corruption of its databases, or a simple power outage.

Organizations need resilience strategies and plans to enable them to return to normal operation in an acceptable period of time. In government, and in key industries such as financial services, health care, and telecom, this acceptable period may be no more than a few hours. Some jurisdictions already have legal and regulatory requirements under which organizations in critical industries must establish resilience and recovery plans. Insurance may also be available to cover technology-related disruptions, although it may not provide any protection against potential brand damage arising from a failure and it won’t bring the systems back up.

A critical component of every organization’s recovery plan must be its ability to recover business records following a technology failure. An inability to retrieve business records could result in a business failure.

**Who owns the technology?**

The CIO may be the organization’s technology leader, but most CIOs are responsible for only some of their organizations’ hardware—usually the corporate, human resources, and accounting systems. Some processes or technologies may be outsourced or managed by third parties, and the CIO may not be sufficiently involved to address the associated risks. Other technologies may be managed by other groups; in manufacturing organizations, for example, the head of manufacturing may be responsible for production technologies such as robots.

This complex technology landscape requires strong governance, and a growing number of organizations have appointed a chief data officer to bring a holistic approach to managing data.

**It’s still all about people**

Despite the heightened role of technology, people are still an organization’s most important asset. Having the right people with the talent and experience needed to manage and operate the organization’s technology will drive the performance of the group.

Not surprisingly, many technology specialists—especially those with cybersecurity skills—are in high demand. To attract them, organizations need to offer a challenging work environment, the opportunity to network with colleagues, and work that will enable them to develop new skills. Organizations that are unable to attract enough people with the required skills will need to rely on outsourced providers or partner with third parties.

In a workplace characterized by continuous change, all employees need training to use new technologies efficiently and maximize the intended benefits. Innovation is also needed, which will require strong teaming between the business and the information technology department.

**Technology and the board**

Today, technology and digital transformation are dominating boardroom agendas, although it’s often unclear what “digital” means. Most definitions are shallow, and the expectations for the journey to a fully digital enterprise are optimistic. For many, it means tinkering with the customer experience, but digital is much more than that.

Digital should be defined based on business needs. For example, to a health care organization, digital might mean using technology to achieve better patient outcomes, while a business-to-business organization’s digital transformation might involve using technology in the supply chain to improve efficiency and decision making.

Boards may need to increase their understanding of technology and its risks, particularly given that many technologies, such as social media, are relatively young and constantly evolving. Boards also need directors who understand how emerging technologies may transform or, in the case of a cyber attack or other failure, disrupt the organization’s business model.
Questions for directors to ask

• How well do we, as a board, understand what digital means in our organization? Do we have sufficient digital expertise at the board level, especially given the pervasiveness of technology in our organization?

• Is our organization focusing its technology efforts on the areas that will have the most impact? Do we have an overall technology strategy? Who has responsibility for technology and how does our organization coordinate its approach to those efforts?

• How well does our organization understand the technology threat landscape? Do we manage these threats appropriately to deal with various scenarios?

• Does the organization understand its critical data and applications and how are they protected? How quickly could we recover those records if they were to be corrupted or destroyed because of a technology failure?

• How successful is our organization at recruiting the cybersecurity specialists and other digital technology experts we need to succeed? Do we need to diversify our approach to talent, such as by working with our business partners to recruit the talent we need?

“Technology is a license to operate in today’s economy, and the technology choices made by an organization should be driven by its business needs. Given the sizeable investment organizations are making in technology, if they are to fully capture all of the benefits of that technology, they need to ensure that those investments are secured and that the organization will be resilient in the face of a cyber attack or other technology failure.”

Chris Verdonck
In the 1920s, the average life span of an S&P company was 67 years. Today, it is 15 years. On average, an S&P company is replaced every two weeks, and Richard Foster of the Yale School of Management estimates that by 2020, 75 percent of today’s S&P 500 companies will be replaced.5

Are legacy organizations today positioned to sustain success in an era of disruption? The answer is yes—if they choose to embrace disruptive technologies and new business models when making strategic and operational decisions.

**Understanding disruption**
To prepare for the future, organizations must understand what is causing disruption today.

Disruptive technologies are deceptive. Once something enters an exponential curve, growth can be deceptive. This is because the initial doublings are so minute that people often mistake them for linear growth. Once these doublings reach a certain threshold, exponential growth is visibly disruptive, and those who did not recognize its value are left trying to catch up and capture opportunities in a reactive fashion.

Convergence is accelerating disruption. Disruption is being accelerated by the proliferation of multiple technologies, combined with globalization, cultural changes, and demographic trends. For example, it is estimated that between three and five billion new people will be connected to the Internet for the first time during the next five years.7 Dubbed “the rising billion,” these individuals will come online as consumers, inventors, and collaborators, extending innovation ecosystems beyond hubs such as Silicon Valley, Tel Aviv, and London.

Competing to win
Technological disruption is being accompanied by a blurring of industry lines and lower barriers for new entrants, causing organizations to redefine their approach to competition.

Consider the automotive industry. Traditional manufacturers must now account for Google as a pioneer of driverless cars and Uber as a more recent entrant, leveraging the sharing economy to limit individuals’ need to own personal cars. Disruptive new entrants to the market are highly agile and often free of the baggage that encumbers older companies, such as fixed assets or static business models.
While many traditional companies have seen their business plans become disrupted, others have learned how to leverage this rapid change to their advantage. What are the keys to competing successfully in a disruptive environment?

Find a disruptive advantage. Established organizations have significant asset bases, including distribution channels, expertise, and experience. By capitalizing on these assets, organizations can achieve a disruptive advantage. For example, although life sciences and financial services companies operate in highly regulated industries, they have found ways to use their extensive expertise to innovate. The financial services industry has been a pioneer in embracing blockchain technology, with more than 50 of the world’s leading financial institutions having formed a consortium, known as R3, to design and deliver advanced distributed ledger technologies to the global financial markets.

Build an ecosystem. Ecosystems of partners, collaborators, and crowds provide the creativity, knowledge, and skills needed to capitalize on innovation. For example, First Build, a partnership between the University of Louisville and General Electric, is a community space where people collaborate to bring their ideas to life. By engaging the community, GE’s program launches an estimated 12 products annually, with ideas going from the mind to the marketplace in three to six months.

Experiment. Most importantly, companies need to become more flexible, experiment, and be willing to fail fast. Organizations have found success by believing that experimentation is critical. They embrace the fundamental notion that “good” might be good enough with the objective of getting concepts to customers quickly, getting immediate feedback, and then experimenting further to fully develop their products and services.

Looking to the longer term
It is impossible to sustain long-term success in the current environment if disruption and innovation are not part of the fabric of the organization. To avoid stagnation, organizations typically need to build a foundation that involves a world-class sensing capability; an agile incubation and experimentation model; and an unwavering commitment to innovation and disruption as part of ideation, evaluation, and rewards. Sensing capabilities enable organizations to track signals of disruption not only inside their own industry, but also outside it to inform experimentation. These sensing capabilities help boards identify truly disruptive opportunities and understand their impact on the organization. Organizations can use that knowledge to experiment with different business models, test ideas in the marketplace, prototype, and develop solutions. Doing so will help organizations capture the potential of disruptive business models, navigate changing market trends, and understand how it all could affect their organizations’ business.

Role of the board
Boards need to stay educated about disruption and truly understand the dynamics and nuances of disruptive technologies, disruptive business models, and the changing geopolitical landscape. They need to ask smart questions and encourage creative thinking with respect to all of the organization’s products and services. Boards should also confirm that management has a comprehensive plan for tracking disruption and the progress they are making toward developing fundamental solutions.

Most importantly, boards and management need the courage to disrupt the organization’s own business model. This can be a challenge, especially when the business has been highly successful in the past and continues to be effective. But every organization will undergo disruption eventually, and those that are successful embrace change as a way to secure their businesses in the future.

To truly sustain success and capitalize on disruption, organizations need to democratize innovation. It is critical to equip all parts of the organization with tools and incentives that encourage experimentation and innovation in the course of day-to-day activities. Innovation focused on improving the core business is critical to complement truly transformational innovation, which often happens on the edge of the organization. Building a balanced portfolio of core and transformational initiatives that are tested and adopted across the organization is what distinguishes successful companies who use disruption to their advantage from those who are disrupted.
Questions for directors to ask

- How does the board stay informed of new trends and understand the potential of new technologies?
- Does the board have a sufficient understanding of innovative disruption, or do we need to consult with outside experts and receive more frequent updates from management?
- Does our organization have the flexibility it needs to succeed today, or are we rooted in the business models, methods, and processes of the past? Do we have the courage to disrupt these models even if they are still producing results?
- Is our organization willing to experiment and take risks? Do our performance evaluation and reward systems encourage appropriate experimentation and risk taking?
- Are we expanding our ecosystem to include new partners, both traditional and start-up, to enhance our ability to develop new concepts?
- Are we tapping into the talent of the crowd and using that power to help us develop new ideas quickly?
- Do we have a clear understanding of our competitors? Are we watching the new start-ups in our field or do we discount them as being too small to be a threat?

“In today’s world of exponential change, organizations that get too comfortable with the status quo are at major risk of disruption. If you’re not experimenting and, as a director, if you’re not asking questions about how your organization is navigating and plugging into disruption, forming new ecosystems, and tapping into open talent markets, then your organization is at risk. In the area of talent alone, if you’re not leveraging talent from outside your organization, you’ll never win the war of ideas because the smartest people in the world don’t work for you.”

Andrew Vaz
A conversation with Edward Chow

In the Asia Pacific region, organizations and their boards face an accelerating pace of change influenced by political events, government regulations, and environmental concerns. These changes come with a number of challenges, including financial, cyber, operational, and reputational risks. Boards are looking for ways to better balance their agendas to achieve financial performance in an unsettled business market.

To gain a director's perspective on the governance landscape in the Asia Pacific region, we spoke with Edward Chow, who shares his thoughts on a number of challenges, including digital disruption, the global regulatory environment, and the changing role of the board.

Chow Kwong Fai Edward is the founding chairman of China Infrastructure Group, a non-executive director of the Urban Renewal Authority, and an independent non-executive director of Melco International Development Limited, Redco Properties Group Limited, and China Aircraft Leasing Group Holdings Limited. He is also a core member of the OECD/World Bank Asian Corporate Governance Roundtable, an adviser of the Business and Professionals Federation of Hong Kong, and a Standing Committee member and convenor of The Chinese People's Political Consultative Conference – Zhejiang Province.

What are the most significant challenges facing organizations today?

Organizations face a number of uncontrollable risks such as, on the big side, a natural disaster, or in a narrower manner, new regulations or restrictions that affect the company's business. These risks come from all directions: economic, political, currency issues, and so on. The result is a big picture that is quite unsettled.

For instance, the world appears to have moved from wanting to globalize into a more narrow-minded, nationalist view and a desire to return to the way things were before trade and other barriers were dismantled. We're seeing a backtracking into different economic and political blocks, which is a concern for more globally represented organizations. These are all uncontrollable and disruptive developments; that causes me to pay careful attention to the overnight news to see what might have happened in Europe and in America that we will need to respond to.

A lot of organizations are being digitally disrupted. Is that another uncontrollable risk?

I have a problem with the word disruption. What to an outsider may appear to be disruption is, from inside the business at the board or management level, a failure to identify the business risks created by fast-paced innovators and their new methods of doing business. Boards cannot turn a blind eye to that. They need to have a solid understanding of the environment in which their companies' various businesses operate, and hence the board should be asking tough questions of management and also within the board itself as to how well the business is performing and whether the organization can mitigate the risks and threats it faces.

However, I do think technological advancements have overtaken management's ability to run the business in a controllable manner, and unfortunately these uncontrollable external forces are growing much faster in terms of risks and threats to the business. So the challenges are coming at a much faster pace and the board has to have the vision, attributes, broad-mindedness, and the depth and breadth to cope; otherwise the company will decline and fail.

You mentioned regulations. What are your concerns?

I am concerned about the regulatory and compliance requirements placed on boards, which have often arisen as a consequence of economic downturns and scandals of one kind or another. Politicians react to these scandals with new legislation, which regulators and standard-setters then turn into new rules that management and the board must comply with and discharge. Today, boards and management spend an extensive amount of time complying with excessive regulatory requirements, which could distract them from where investors...
and shareholders want them to focus—on improving performance. I doubt that any investor or shareholder would thank the board for scoring perfectly on compliance while the company is underperforming.

This situation is of particular concern in the financial services sector. Since 2008, the regulatory requirements have become heavier and heavier. Regulators in the United States, the United Kingdom, and the European Union have all set new rules, in addition to the Basel and Financial Stability Forum requirements, and all the rules around anti-money-laundering and know-your-client requirements. Global banks must comply with all of these regulations, which are stifling their operations. World economic growth is slowing because businesses are being constrained by regulatory overload.

Within the board, the current level of overregulation is also a concern, particularly for recruiting and retaining strong non-executive and independent directors whose livelihood does not depend on board membership. The current regulatory environment has caused many great people to shy away from accepting board appointments.

Speaking of boards of directors and regulations, there is a push to have more women on boards. What other changes are we seeing in board composition?

Gender balance, while desirable, is not a top priority for me as long as both genders are present at the board level. An exclusively male or female board may not be desirable, but the presence of both genders, even if it isn't 50-50, would serve to yield some balance.

I think gender is just one area where board membership is changing. Looking ahead, in my part of the world, the average age of directors has been rapidly falling, which is resulting in a younger board mindset; I expect to see this trend continue. I would also expect to see more employee representatives on the board. Boards will also need members with expertise in areas such as technology, which moves at an increasingly fast pace; industry expertise; and, in a global environment, regional expertise. Boards will need expertise at all of these levels, together with a macro-broadmindedness.

Another recurring concern is transparency. Are organizations doing enough to ensure that stakeholders understand what is happening?

Today, shareholders and stakeholders are bombarded with information, but I see the disclosures as being something like a dictionary in terms of providing the required information. While people may not read everything, the disclosures should refer them to where they can find the information they need, whether it is in the annual report, periodical reports, or on the company’s website. So, as long as people can obtain the information they need, I do not see the system as being dysfunctional.

On the other hand, where opportunities exist to meet face to face with the shareholders or stakeholders or even the people who write research and media reports, the board, and the non-executive directors in particular, shouldn’t be absent or hide behind the management. I have attended shareholders’ meetings where, when questions are asked, responses by the independent and non-executive directors often carry more weight than management’s responses because of the directors’ independence, background, and other credentials.
“Today, boards and management spend an extensive amount of time complying with excessive regulatory requirements, which could distract them from where investors and shareholders want them to focus—on improving performance.”

Edward Chow
Given some of the concerns you’ve raised, do you think we need a new model of governance?
To me, the new model of effective governance is already being practiced. By that, I mean that independent non-executive directors already spend considerable time overseeing the organization, which they need to do to fulfill and discharge their duties to shareholders.

The simple, classical definition of the role of the board is stewardship. Like the captain of a ship or an airplane, directors need to guide management as to whether it is time to play it safe and retrench or it is time to grow and diversify. To do that effectively, directors need to ask tough questions about economic, political, social, and environmental issues and determine whether these will impact the company favorably or adversely.

One big difference in boards that I do see today is that the standard to which board directors are held is much higher than it was in the past, because of the more complex environment in which companies operate, particularly with today’s very fast-moving innovative technologies that are creating new businesses and new modes of doing business. This is a very challenging environment and one that can change quickly. As you know, we’ve seen companies that quickly rose to become the darlings of investors and the markets a few years ago that have, since then, just as quickly gone out of fashion and sometimes also out of business. This pace of business growth and decline is a new phenomenon.

Looking ahead, what challenges do you see facing boards of directors and organizations?
Boards will need to continue to achieve a balance between regulatory compliance and operational performance, and the organization’s ability to operate in a safe socially and environmentally responsible manner. We’re seeing new challenges arising—care for the environment has long been a concern, but global warming is also very high on today’s agenda—and boards need to keep all of these balls in the air in order to discharge their duties effectively.

Today, it’s much more difficult to run a business smoothly than it was in the past and, looking forward, new challenges will surface and the board needs to be fit to address them. If the board doesn’t have the required capabilities, it should take steps to enrich its skill sets, attributes, perspectives, and so on, so it will be able to steer the company forward and be answerable to the shareholders and the stakeholders. However, just because a company is not growing as fast as its competition, it doesn’t mean it is dying. But, an organization that is too ambitious or is not fully aware of the threats and risks may become marginalized or, at worst, be driven out of business.
Executive pay has become a symbol of inequality and, to some extent, it is seen as a symptom of wider societal issues. For their part, shareholders may view high pay, especially when it does not appear to be linked to the organization’s performance, as an indication of poor corporate governance.

Board compensation committees have a challenging role in this environment. Determining a structure and level of compensation that considers the needs of the organization, shareholders, and management is difficult enough without having to do so under the watchful eye of the media, legislators, and the public at large. The intense scrutiny of compensation committees and the controversy surrounding their decisions are only likely to increase.

European countries will soon allow “say on pay” votes, similar to those required in the United Kingdom and the United States, necessitating more transparent disclosure of executive compensation so shareholders can cast their votes wisely.

Regulations are also growing stiffer in the United States, where the SEC will require companies to disclose the ratio between the CEO’s total compensation and that of the median employee for fiscal years beginning on or after January 2017. Disclosure of the CEO’s total annual compensation is already mandated. The new rule is a requirement of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 and is intended to help shareholders understand and challenge the executive pay practices at major companies.

The United Kingdom may require even greater disclosures. Theresa May, now prime minister, said in May 2016, “There is an irrational, unhealthy, and growing gap between what ... companies pay their workers and what they pay their bosses. I want to make shareholder votes on corporate pay not just advisory but binding. I want to see more transparency, including the full disclosure of bonus targets and the publication of 'pay multiple' data: that is, the ratio between the CEO’s pay and the average company worker’s pay. And I want to simplify the way bonuses are paid so that the bosses’ incentives are better aligned with the long-term interests of the company and its shareholders.”

Understanding executive pay

Executive pay has increased significantly in recent years when compared to the pay of other employees. In part, this reflects the greater difficulty of recruiting top executives in a globalized market where only a limited number of people have the experience needed to lead a major organization. Required disclosure of CEO compensation may also contribute to the rise in executive pay levels, because many organizations benchmark their levels against those of executives at similar companies. Compensation committees need to be mindful of their organizations’ compensation policies for the wider employee population to ensure that success is shared fairly.

The role of executive compensation is to support the organization in delivering its business strategy. For that reason, the majority of the compensation received by CEOs and other executives is through performance-related pay, which is intended to incentivize them to achieve targets related to strategic objectives and to operate the organization for the benefit of its shareholders. To be effective, the targets set by the compensation
committee need to be ambitious enough to represent success for shareholders, while also being realistic for management. A further challenge when setting performance targets is the need to balance the sometimes conflicting views of different stakeholders.

When the organization’s strategy changes, it may affect the structure of executive pay and incentives, so organizations will need to consider whether their compensation arrangements continue to be aligned with strategy or whether they need to be adjusted.

Consider, for example, the impact Brexit may have on the perceived performance of UK-based organizations. In the wake of the United Kingdom’s decision to leave the European Union, the value of the UK pound dropped significantly against other global currencies. That will benefit UK companies with significant overseas operations when they translate overseas earnings into pounds sterling. In this type of situation, the compensation committee needs to exercise careful judgment when determining incentives, taking into account the overall performance of the organization in circumstances that are generally outside management’s control.

Given continuing uncertainty in the global economy, organizations will need to draft compensation policies with sufficient flexibility in areas such as performance measures and targets to confirm that their compensation structures continue to reward underlying performance.

Care must be taken to ensure that executive pay doesn’t inadvertently incentivize bad or overly risky behavior.

Engaging with shareholders and other stakeholders
Shareholders will question the compensation provided to the CEO when they perceive it to be excessive given the performance of the company.

In some cases, shareholders and other stakeholders may lack a sufficient understanding of the organization’s pay-for-performance policies. Although disclosures related to executive compensation can run as long as 20 pages, descriptions are often plagued by boilerplate that is hardly illuminating, and compensation committees may find themselves having to defend their decisions in front of angry shareholders at the annual meeting. If compensation committees view the proxy statement or remuneration report as a communication tool, they can provide shareholders with clear information that will help them understand the choices that were made and the reasons for them.

Faced with more stringent requirements for disclosure, many organizations may be reluctant to offer greater detail pertaining to executive pay. There are, however, other measures that may be more useful in helping shareholders and other stakeholders understand the compensation system. Rather than disclosing a single ratio of CEO versus employee pay, a fuller picture might be presented by providing a broader set of ratios—for example, data on how the top decile of the organization’s compensation compares to the lowest decile, or a comparison of the total incentives paid to management compared to those paid to all employees. More qualitative explanations could provide a clearer picture of how financial success is shared across the organization—for example, information on improvements to employee benefits or employee share plans and bonus pools.

Additional context can be provided by charts comparing long-term pay with the long-term performance of the organization, metrics indicating how the company’s performance compares that of similar organizations, or historical information.

The role and structure of the compensation committee
When the media reports incidents of overly generous compensation being paid to executives in return for mediocre corporate performance, public scrutiny inevitably turns to the compensation committee. It often appears that the committee did not apply enough rigor to the process or did not consider management compensation in the context of all the organization’s stakeholders.

It can take courage to be an effective member of a compensation committee. The structure of the board and the various board-level committees, and their relationship with management, may inhibit members from acting effectively. For example, how independent are compensation committee members in situations where the CEO can influence their future on the board?

Committees should also guard against overreliance on benchmarking when setting compensation levels. Data comparing the CEO’s compensation with that paid by similar companies can help confirm that pay levels are competitive, but benchmarking can also lead to “chasing the median,” where the size of rewards rises continually as each organization tries to outpace the others in the quest for talent.
Questions for directors to ask

- Do we place too much reliance on formulaic outcomes from variable pay plans rather than exercising judgment and discretion in setting remuneration targets and payouts?

- Do we challenge the recommendations of compensation consultants? Does our reliance on the consultants’ recommendations mean we are avoiding making tough decisions ourselves?

- How well do shareholders and other stakeholders understand our executive compensation structure? Is it too complex to be explained easily? Do we need to do a better job at communicating our policies?

- Are members of the compensation committee sufficiently independent of management to act effectively? Does the committee have the sole responsibility for compensation decisions, or is the full board also engaged in the process?

- When management doesn’t meet targets, do we revise the compensation accordingly, or do we tend to accept management’s justifications at face value?

“Directors need to be encouraged to act for the benefit of a wider stakeholder group and find ways to focus more strongly on long-term stewardship rather than simply maximizing shareholder returns. They should consider ways in which there could be a greater sharing of success among all employees. Everyone involved in the process needs to look at ways in which shareholders can be encouraged to actively engage with companies and ways in which the governance of compensation committees can be improved.”

Stephen Cahill
European organizations face a complex and rapidly changing regulatory environment, including new rules for disclosure and transparency and the need for boards to diversify in response to local and regional legislation. The effectiveness of boards’ responses to these challenges will be critical to the continuing success of their organizations, especially those that operate primarily in Europe, where economic growth is still slower than anticipated.

To gain a director’s perspective, we spoke with Cesare Bisoni, who discussed the changing role of boards of directors, the challenges facing boards, and the need to maintain a longer-term focus in an uncertain operating environment.

You’ve served on boards for several years. How has the role of director changed over that time?

In my opinion, one of the biggest changes is in the activities and responsibilities of directors, which have become much more complex than they used to be, especially since the 2008 financial crisis. Today, we’re still dealing with ongoing market instability as a result of that crisis, and the markets are further destabilized by geopolitical events such as Brexit. All of this creates an unpredictable business environment, and that makes it harder for boards to evaluate the various scenarios they need to consider when making decisions. It also means that boards and management must spend much more time continuously monitoring the developments affecting those decisions.

Another challenge that has grown considerably since 2008, particularly in the financial sector, is the increasingly complex and growing regulatory environment. Today, boards deal with many more regulatory issues than in the past, and in much more detail. The time boards must devote to regulatory matters is time they don’t have to address their other important responsibilities, such as setting strategy, and that is a concern.

Two other issues that add further layers of complexity to the issues faced by boards include the growing risk of cyber attacks, which are especially of concern in the financial sector, and sustainability. Both of these are issues that boards have to spend more time monitoring and ensuring that management is managing them.

How does this uncertainty affect the board’s decision making?

Uncertain environments make decision making more difficult. In some cases, an organization may realize a competitive advantage if its board and management can base their decisions on better forecasts and data analytics than their competitors can. On the other hand, a lot of organizations find this environment makes it much more difficult to achieve their strategic plans.

Because of the high degree of market uncertainty, decisions made by the board today involve a higher degree of risk. For that reason, I believe it is very important for companies to develop an appropriate risk culture. Boards need to pay close attention to how effectively the organizations’ internal control and risk management systems are operating. However, the risk culture needs to extend beyond the board and management to include everyone in the organization.

It’s also important that the organization has the right key performance indicators in place—although these can be more difficult to identify than in the past—and boards need to receive information about these KPIs and examine them on a regular basis to monitor management and understand how effectively the organizations are achieving their strategic objectives. For that reason, organizations need to be more flexible...
than they might have been in the past. All decisions need to be reviewed periodically because circumstances are always changing, and when they do, the organization needs to be agile enough to respond appropriately. Changing conditions can’t be ignored without risking the viability of the company.

Is flexibility incompatible with having a longer-term focus?
No, I don’t believe so. I think it is important that boards retain a long-term focus. The board should also make sure that management has the same long-term perspective, which the board needs to reinforce through management’s pay and incentives.

If you want to have a long-term perspective, then you also need to have a long-term vision, and therefore you need to dedicate the time and resources for research and analysis. The information flows throughout the company should also support a long-term perspective. Boards and management need to challenge every level of the organization from this point of view. I would say that having a strong, long-term perspective is essential if the board is to make the right decisions and it could very well be the real condition for ensuring the success of the company.

What changes have you seen in terms of the board itself?
In recent years, we’ve seen a considerable increase in the number of female board members in Italy, which is the result of legislation passed a few years ago. From my experience, it has been a major step forward in terms of gender equality.

In a broader way, we’re seeing a much greater appreciation of the need for diversity at the board level, whether that diversity is in terms of education, skills, expertise, age, or other factors. When boards bring together different viewpoints, it generates more productive debates. Over the next few years, I believe we will see even more diverse boards, and that will lead to benefits in terms of better-quality decision making.

How has the increased complexity in the issues facing boards affected the way boards function?
The skill sets and expertise that were once desirable to have in a director have now become an absolute necessity. More than ever before, to be successful, boards need to recruit top-quality directors. Attracting those top-quality directors is going to become more difficult in the future. The demands on directors are growing, and directors need to ensure that they devote sufficient time to their boardroom responsibilities. For that reason, I would argue that being a director is incompatible with having any other job, especially for directors of large multinational companies. As the number of matters boards need to deal with increases, the time required to address those matters also steadily increases. This is more than just having the time to attend board meetings; it also includes the time to prepare for board meetings. The information packages provided to directors are growing in size and complexity, and it takes more and
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more time to read them and understand the issues. If directors don’t devote sufficient time to properly prepare for the meetings, they won’t be effective in challenging management on the issues and holding management to account.

The skills and personal qualities of directors are a crucial starting point for ensuring that the board is able to play an effective role, but it is equally important that board members have periodic orientation and induction meetings. There used to be less of a need for them, but now I would argue that they are urgently required.

**How has the push for greater transparency affected the board?**

I believe this is one of the biggest areas of change for boards. A lot of the discussion around transparency is in terms of how greater transparency might create a stronger relationship between the organization and its stakeholders and with the market in general. But it is also changing the relationship between the board and management. With the new rules around transparency, boards need to demand a higher level of disclosure from management than they did in the past. That improved disclosure should then have a positive impact on the level of discussion in board meetings and on the ability of directors to delve deeply into the issues, which could lead to better decision making.

**When it comes to uncertainty, digital disruption is a big factor. How well are boards coming to grips with that?**

This is a big, complex issue not only for boards but also management, and it affects every organization in every sector. Without a deep understanding of the business, it is difficult to be able to perceive and understand what might disrupt the business. Boards that are composed of people with different areas of expertise, or who come from different industry sectors, might find it difficult to stay ahead of developments that may disrupt the company. Given that, it is primarily management’s responsibility to understand what is happening in the industry, and management must provide the board with its analysis and take the time to share opinions and answer questions so directors gain a full understanding of the issues related to disruption.

Of course, much depends on management’s ability to gain an understanding of all the issues, including ones that may arise in future, and this can be quite difficult. So, it is a weak spot for boards because the board is dependent on management, and if management doesn’t do its work properly, then directors will have a difficult time staying on top of these issues.

**What are some key considerations for longer-term success?**

As I’ve said, all decisions today are difficult ones because of the uncertainty in the markets, and boards, management, and organizations need to learn how to operate effectively in this environment. We don’t know when the so-called advanced economies will start growing again, but we do know there will likely be continuing volatility in the financial markets, and regulatory pressures will continue to increase. All of that will generate higher costs, and decision making will involve greater risks.

How successfully an organization manages its way through all of this will depend very much on the quality of the board and the management team. It is important, therefore, that the board has a succession plan in place for itself as well as a plan to ensure that the company continues to attract the top-quality people that it needs to succeed, especially a top-quality management team.
“The skills and personal qualities of directors are a crucial starting point for ensuring that the board is able to play an effective role, but it is equally important that board members have periodic orientation and induction meetings. There used to be less of a need for them, but now I would argue that they are urgently required.”

Cesare Bisoni
As public scrutiny of boards of directors increases, the question arises: How well are boards set up for success? Shareholders, employees, and the broader community need to be confident that boards are making the best possible decisions.

Board effectiveness has usually focused on the capabilities, skills, and experience of individual members. While the qualifications of the members are critical, there is an emerging emphasis on the board as a team and on its collective intelligence. This overall board IQ isn’t a reflection of the average or even the maximum intelligence of board members; research demonstrates that groups are more than the sum of their parts and collective intelligence is the property of the group itself. Moreover, collective intelligence has measurable value. Just as individual intelligence enhances individual performance on complex problem-solving tasks, collective intelligence improves the group’s performance.

Having confirmed an intuitive belief that two heads are better than one, closer attention is now being paid to the factors that drive collective intelligence and ways to avoid “group think.” Research points to three critical elements:

1. **Board composition.** Does the board have diversity of thinking? When problems are solved from a single perspective, be it that of an individual or a homogenous group, there is an inherent error rate of approximately 30 percent.

2. **Structure of conversations.** Are discussions between board members designed to ensure that each person has an equal voice? Without structure, conversations are likely to be dominated by a vocal few and are subject to unconscious biases.

3. **Leadership.** Does the chairperson create an inclusive environment where all members are treated fairly, feel valued, and are encouraged to speak up? The objective is to stimulate robust and thoughtful debates.

Conversational structure and inclusive leadership are well-covered ground. It is the first of these elements—board composition and diversity of thinking—that is the most difficult. The challenge lies in defining the kinds of diversity that lead to collective intelligence, as well as their proportions and how they are interconnected. Without these details, diversity of thinking is no more than an enticing concept, and certainly not a practical tool.

Unsurprisingly, this challenge has generated a wide range of studies. Some have pointed to the value of gender balance, others to the importance of a group whose members have held diverse functional roles (e.g., CFO, CMO, and CHRO). Still others stress the importance of racial diversity. If each claim is valid, how do the findings hang together?

Research helps makes sense of these disparate factors and adds another critical consideration: how individuals tend to approach problem solving.

Diversity of gender, experience, race, age, and problem-solving approach has clear benefits, but some factors influence diversity of thinking much more directly than others. A combination of direct and indirect factors is ideal for optimal performance and collective intelligence.
Direct factors
Individual approaches to problem solving
Individuals tend to solve problems using one or two of six approaches, particularly when they are under pressure or in like-minded groups. These six approaches are:

- **Outcomes.** Closely defining desired objectives
- **Options.** Creating an exhaustive list of possibilities
- **Process.** Giving absolute clarity to an implementation plan
- **Evidence.** Relying on robust and multiple sources of data
- **People.** Identifying diverse audiences and their interests
- **Risk.** Predicting and addressing multiple scenarios

All six approaches are critical to a well-rounded solution and all board members are capable of addressing them to some degree, but as individuals, we tend to believe that one or two are the most important.

This results in a tendency to favor those options and produces conversations and solutions that overemphasize some dimensions and undervalue others. Indeed, executive groups are often dominated (75 percent) by people who tend to focus on defining the outcomes they want to achieve and identifying the options for getting there. Individuals who think of problems in terms of the other four dimensions—people, process, risk, and evidence—report that much less time and attention is given to their views. This presents obvious risks, both in the selection of board members and in the solutions that are likely to be developed by executive teams and presented to boards.

Greater transparency into individual approaches and the weight of the group’s preference enables boards to select members for diversity of thinking in terms of problem-solving approaches, or at least to self-correct if there is a natural conversational bias. More balanced conversations help reduce blind spots (minus 30 percent) and promote innovation (plus 20 percent). Moreover, the board’s capacity for collective intelligence is likely to be recognized by those outside the board, stimulating greater levels of confidence in the analysts, investors, and regulators who follow their decisions.

Indirect factors
Collective intelligence is also influenced by gender balance and racial and cultural diversity. Boards should reflect the diversity of the organization’s underlying employee and customer populations to promote market confidence and sensitivity, but there are additional indirect benefits.

Gender balance promotes psychological safety and more conversational turn-taking, thereby encouraging people to speak up, offer their views, and elaborate on the ideas of others. Racial diversity triggers curiosity, causing people to ask more questions, make fewer assumptions, listen more closely, and process information more deeply. The indirect value lies in the positive influence of gender balance and racial diversity on conversational dynamics, subtly helping to elicit latent diversity of thinking.

The bottom line is that by attending to the factors that drive collective intelligence, boards can help themselves make smarter, more innovative decisions and boost their own confidence, as well as that of their stakeholders. Viewing the board as a small team that needs a balance of individual problem-solving approaches and a diverse set of experience will help members focus on the direct drivers of diversity of thinking. A focus on gender balance and racial diversity, worthy in its own right, will also help create a board environment that is more conducive to diverse views.

Variety of disciplines or functional roles
A second direct influence on diversity of thinking comes from the mix of functional roles (such as general counsel, CRO, CIO, CMO, or CHRO) held by board members earlier in their careers. These executive roles expose members to different domains of knowledge and social networks. The productive value of this kind of diversity has been well documented, and boards have become much more conscious about selecting members from beyond the stable of CEOs, CFOs, and COOs. There is obvious value in tapping and integrating diverse knowledge domains as a means of increasing collective intelligence. The challenge is to keep that insight in focus. The additional value of diverse social networks for sourcing and disseminating ideas is often underestimated.
Questions for directors to ask

- Who are we? Does our team display diverse thinking? Have we held diverse roles? Do we approach problems in different ways? Are we presented with organizational strategies that are balanced?
- How do we converse? Do we operate in a collaborative and respectful way? Would each board member say he or she feels confident to speak up, even to express a point of view that is different from the majority?
- How are we led? Do we have a chairperson and/or CEO who is highly inclusive?
- How do we influence our organization? Do we ask powerful questions to ensure that diversity of thinking is a priority?

“Boards are under extreme pressure to make smart decisions about increasingly complex issues under the spotlight of public scrutiny. Instead of feeling overwhelmed, our research has identified ways that boards can lift their collective intelligence and, therefore, be more confident about their decisions.”

Juliet Bourke

A conversation with Kazuhiko Toyama

The new Japanese Corporate Governance Code took effect in June 2015, which requires companies to reform their boards and voluntarily make transparent, fair, timely, and effective decisions to increase corporate value. The code delineates the board’s responsibilities, which include setting the corporate strategy; establishing an environment that supports appropriate risk-taking by senior management; and carrying out more effective oversight of directors and management from an independent and objective standpoint. The code also describes the roles and responsibilities of independent directors and recommends that companies appoint them to their boards.

We spoke with Kazuhiko Toyama, the CEO of Industrial Growth Platform, Inc., and an independent director of OMRON Corporation, Pia Corporation, and Panasonic Corporation. Mr. Toyama is also an expert member of the Council on Economic Fiscal Policy, a member of The Tax Commission, and a member of the Council of Experts Concerning the Corporate Governance Code. He was previously the COO of the Industrial Revitalization Corporation of Japan, which was established by the Japanese government in 2003.

How will the new rules change boards in Japan?
Classically, Japanese boards have been very formal and were an extension of the company’s internal management board. Board meetings were nothing more than a rubber-stamp exercise because, by the time the board met, most corporate decisions had already been made by the executive board members. Now, under the new code, the board must be more of an oversight board, monitoring and supervising management; the independent directors play a key role in that monitoring. It is a very big change for Japanese companies.

How has the role of outside directors changed?
In the past, outside directors were nothing more than advisers to the executive board members. Now, they are responsible for monitoring management, and that includes being proactive in decisions around the company’s strategy, the selection of the CEO and other top management members, and risk control—all of which used to be decided by management. This is a very big change, but I think it will probably take about five years before we see the full impact.

For example, many outside directors were passive and reactive, and it will take time for them to become comfortable with their new roles. Boards are also trying to create more direct channels from inside the company to report directly to the board, and in particular to the outside directors.

Another constraint is that although Japanese companies have started appointing more outside directors to their boards, it will take time to reach the desired level of 30 percent of outside directors because there is currently a limited number of people in Japan who are qualified to act as independent directors.

The responsibilities of an outside director are also substantial; it’s a big job, and that limits the number of boards a director can sit on.

What’s the solution?
Diversity is a big part of the solution. Traditionally, the boards of Japanese companies were very homogenous. They were made up almost exclusively of males in their 50s and 60s who were Japanese nationals. To recruit the necessary outside directors, companies need to look outside that traditional group, and that includes more women, people from different generations, and also recruiting directors from Europe, North America, and other parts of Asia where there is a much larger pool of people qualified to be independent directors.

In terms of knowledge and expertise, boards are also looking to outside directors to bring wider perspectives to the board. For example, since risk control is now a key responsibility of the board, boards need to recruit people with expertise in that area, such as accountants. They’ll also need to recruit outside directors who have skills and expertise in the other areas of the board’s responsibilities. Altogether, it will result in much more diverse boards than in the past.
“To recruit the necessary outside directors, companies need to look outside that traditional group, and that includes more women, people from different generations, and also recruiting directors from Europe, North America, and other parts of Asia where there is a much larger pool of people qualified to be independent directors.”

Kazuhiko Toyama
New international auditing standards that require enhanced reporting by the auditor to provide greater transparency will be effective this year. Some jurisdictions, such as the United Kingdom, also require reporting by the audit committee. These expanded reports may intersect and influence the clarity and usefulness of information provided to shareholders.

**Enhanced auditor reports**

Although the new rules will result in greater disclosure, will they also provide greater clarity?

The International Auditing and Assurance Standards Board’s (IAASB) new standards come into effect for periods ending on or after December 15, 2016. Some countries, such as the United Kingdom and the Netherlands, already require similar reporting. Others, such as Germany, require “long-form” reporting and have included auditor reporting requirements in their local regulations for some time. These local rules usually differ from those of the IAASB.

According to the IAASB,16 enhanced auditor reports are intended to:

- Improve communication between auditors and investors, as well as those charged with corporate governance
- Raise user confidence in audit reports and financial statements
- Heighten transparency, audit quality, and information value
- Concentrate the attention of management and financial statement preparers on disclosures referenced in the auditor’s report
- Renew auditor focus on matters that could result in an increase in professional skepticism
- Enhance financial reporting in the public interest.

A primary component of the enhanced auditor’s report is a discussion of “those matters that, in the auditor’s professional judgment, were of most significance in the audit of the financial statements of the current period. Key audit matters are selected from matters communicated with those charged with governance.”17

The new auditor’s report will also disclose the name of the engagement partner.

In the United States, the Public Company Accounting Oversight Board is considering similar rules. It issued a reproposed auditor reporting standard for public comment in May 2016.

“Enhanced disclosures create opportunities for auditors and audit committees to give shareholders and other stakeholders a better understanding of what happened over the past period.”

Jennifer Haskell

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Global Audit Quality Leader
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Chair, Global Audit Technical Advisory Board
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Audit committee reporting
The UK Corporate Governance Code requires companies to include a separate section in the annual reporting to describe the work of the audit committee. The report is to include:

- Significant issues that the committee considered in relation to the financial statements and how these issues were addressed
- An explanation of how the committee assessed the effectiveness of the external audit process and the approach taken to the appointment or reappointment of the external auditor
- Information on the length of tenure of the current audit firm and when a tender process was last conducted
- An explanation of how auditor objectivity and independence are safeguarded if the external auditor provides nonaudit services.\textsuperscript{18}

In the United States, a group of corporate governance and policy organizations issued a call to action in November 2013 encouraging improved audit committee disclosures, stating, “We believe that greater transparency about the audit committee’s roles and responsibilities is one way of increasing investor confidence, and an opportunity to communicate more clearly to shareholders about audit committee-related activities.”\textsuperscript{19}

The US Securities and Exchange Commission published a concept release in July 2015 to seek public comment on possible revisions to audit committee reporting requirements, and specifically on the audit committee’s oversight of the independent auditor. The SEC is determining its next steps in this area.

Disclosure considerations
The enhanced auditor and audit committee reports are in addition to the vast amount of information companies already disclose in their financial statements, annual reporting, and other materials. Many organizations’ annual reporting already runs to several hundred pages, so is there a risk that users will view the discussion of key audit matters in the auditor’s report as a shortcut to avoid reading the rest of the disclosures?

Management is responsible for preparing the financial statements and all of the related disclosures, and it is neither the auditor’s role nor its responsibility to disclose information about the organization. The auditor’s description of a key audit matter usually does not constitute new information about the organization; however, if the auditor needs to include additional information to explain why the matter was considered significant and how it was addressed in the audit, disclosure is permitted. In these situations, the auditor may encourage management or those charged with governance to disclose this additional information themselves.

Users should be aware that not all auditor reports are comparable. Jurisdictions that already had auditor reporting requirements in place often have rules different from those of the IAASB. Auditors may need to adjust their reports to comply with the requirements of both local laws and IAASB standards.

For organizations operating in jurisdictions that do not require enhanced audit committee reporting, there is a concern that an expanded auditor’s report, on its own, will present only one perspective. To provide additional context for the auditor’s comments, audit committees may wish to provide their own enhanced reports to discuss how they addressed key audit matters and other steps they took to discharge their responsibilities.
Questions for directors to ask

• Are we comfortable with the auditor’s discussion of key audit matters? How do these matters compare with those of our peers? Should management respond to the key audit matters in its annual or other reporting and explain how internal control over financial reporting mitigates risks and issues?

• If we aren’t required to provide an enhanced audit committee report, will we do so voluntarily? If so, what topics will we discuss in our report?

• Matters related to the audit often involve significant judgment on the part of the auditor; if an expanded audit committee report is being issued, have we considered how we will address and discuss those subjects and judgments?

• How can we improve the usefulness of our other disclosures? Do we organize the information in a logical way? Do we rely too heavily on boilerplate descriptions? Do we present matters in plain English so all stakeholders can understand them, or are our discussions phrased in a way that is understandable only to sophisticated, experienced users?

“There’s a growing public awareness of good disclosure practices, and a growing expectation that disclosures will provide value-added information. These new disclosures should give users insights into the minds of the auditor and audit committee members to give them a more focused view of their work and how they arrived at their decisions.”

Cal Buss
Courage is needed now more than ever on boards and in the C-suite. The global economy, in its sixth year of stagnation, isn’t likely to improve soon, according to the Conference Board. At the same time, other features of the business environment are expected to be highly volatile as a result of geopolitical issues, technological developments, and regulatory and policy uncertainties—particularly as the world waits to see what direction will be taken by the new US administration.

Courage is also needed to face pressures from outside the boardroom. Regulators, stakeholders, and the media continue to scrutinize how boards discharge their governance duties.

While the issues facing boards continue to grow in both number and complexity, the time boards have to address those issues remains finite. Today, boards are challenged to allocate time to matters they are expected to address, especially the critical strategic and risk oversight issues affecting their organizations. Boards need to act courageously to make difficult long-term choices in this environment, particularly if those choices create short-term dissent among stakeholders.

**The board and risk**

Risk is intrinsic to the successful operation of a business. Given the current marketplace volatility, organizations and their boards will need to provide greater oversight in taking the right risks to successfully seize opportunities in changing market conditions, whether they relate to technology, strategy, culture, compensation, or any of the other topics discussed in this publication.

But how well positioned are boards to take on this responsibility for these emerging risks? Do boards even have a clear picture of the risks facing their organizations?

While the board has the overall responsibility for risk oversight, much of that work has often fallen to the audit committee. But given the significant increase in the audit committee’s responsibilities in recent years and the fact that organizations face a growing array of nonfinancial risks, boards are considering new models. For example, organizations may wish to consider replicating a practice from the financial services sector, where certain banking institutions are required to have a board-level risk committee.
As part of their overall responsibility for risk oversight, boards should:

- Define their risk oversight role

- Work with management to arrive at an appropriate risk appetite and risk tolerance for the organization

- Oversee and assist management in incorporating strategic risk into the organization’s strategy

- Consider appointing a chief risk officer

- Ensure that the oversight of each potential risk is assigned to a board committee, as appropriate

- Assess the maturity of the organization’s risk governance process

- Conduct crisis simulations to test the effectiveness of the organization’s recovery plans and better prepare for potential scenarios

- Ensure that the organization discloses its risk strategy to stakeholders.

Stakeholders need to understand how organizations and their boards oversee the increasing number of risks companies must confront. Because every organization has the potential to encounter new risks and unexpected negative events, boards and management must show courage to handle unforeseen circumstances and mitigate any reputational damage that may result.

We hope the views expressed in this publication will lend you courage and stimulate discussions around your boardroom table. We encourage you to contact your Deloitte partner to continue these conversations.
“As organizations continue to face an increasing number of risks and obstacles, boards should challenge management and themselves to do what’s best for the organization for the long-term. While each organization will have a unique set of challenges as they enter 2017, boards should have a renewed look into how the organization is preparing for the unexpected, taking the necessary risks for future success, and devoting sufficient time to oversee risks—all in an effort to help pave the way for their success.”

Henry Ristuccia
Endnotes


8. [http://www.r3cev.com/about](http://www.r3cev.com/about)


12. Ibid.


18. UK Corporate Governance Code (September 2014), section C.3.8

19. Enhancing the Audit Committee Report: A Call to Action, AuditCommitteeCollaboration.org

Resources

Want to dig deeper? We've selected the following Deloitte Points of View to help you better identify potential risks and opportunities these issues present for your organization.

**Strategy**
- Deloitte/SEB CFO Survey: Increased worries about business climate and own financial position (Deloitte Sweden)
- Extended enterprise risk management (Deloitte Canada)
- Framing strategic risk in the boardroom (Deloitte US)
- Long termism and shareholder engagement (Deloitte Canada Directors’ Series)
- The future belongs to the bold: Canada needs more courage (Deloitte Canada)
- The link between strategy and disruption – implications for the board (Deloitte Canada Directors’ Series)
- Unlocking the flexible organization (Deloitte Global)

**Culture**
- Corporate Culture Threatens Digital Progress (Deloitte US)
- Governance in brief: FRC reinforces the importance of corporate culture (Deloitte UK)
- L’équation de la confiance: à l’épreuve des faits (Deloitte France)
- Global Human Capital Trends 2016 (Deloitte Global)
- The Culture of Risk: The importance of managing conduct risk and maintaining an effective risk culture across the business (Deloitte India)
- The way to risk culture (Deloitte Russia)
- Understanding Culture (Deloitte UK)

**Technology**
- 2016–2017 Global CIO Survey: Navigating legacy: Charting the course to business value (Deloitte Global)
- Aligning the organization for its digital future (Deloitte University Press)
- Cyber security: The changing role of the Board and the Audit Committee (Deloitte India)
- Tech Trends 2016: Innovating in the digital era (Deloitte University Press)
- Technology, Media & Telecommunications Predictions 2017 (Deloitte Global)

**Innovation**
- Change initiatives: Managing the Wheel of Woe execution risks (Deloitte University Press)
- Crunch Time: Finance in a Digital World (Deloitte US)
- Radical Innovation and Growth – Global Board Survey 2016 (Deloitte Global)
- Tech Trends 2016: Innovating in the digital era (Deloitte University Press)
- The Deloitte Innovation Survey 2015 (Deloitte Luxembourg)

**Compensation**
- Be careful what you wish for: Simplifying executive pay (Deloitte UK)
- Preparing for the New CEO Pay Ratio Disclosure Requirement (Deloitte US)
- The heat is on: Reforming the executive pay (Deloitte UK)

**Board effectiveness**
- Advancing board effectiveness with a new strategic framework (Deloitte US Dbriefs Webcast)
- Board effectiveness: A focus on behavior (Deloitte United States)
- Courage in the boardroom: winning in uncertain times (Deloitte Australia)
- Diversity in the boardroom: Moving beyond the “Why” (Deloitte Canada Directors’ Series)
- India: Regulatory Expectations impacting Banking and Capital Markets (Deloitte India)

**Transparency**
- Audit Committee Resource Guide (Deloitte US)
- Auditor reporting and oversight (Deloitte Global)
- Clear, transparent reporting: The new auditor’s report (Deloitte South Africa)

**Risk oversight**
- The future of risk: New game, new rules (Deloitte US)
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