# Audit Committee Institute

**On the 2018 Board agenda**

Board agendas should continue to evolve in 2018 as the game-changing implications of technology/digital innovation, scrutiny of corporate culture and leadership, growing demands for companies to address environmental and social issues, and investor expectations for greater board engagement and diversity and long-term corporate performance all drive a sharper focus on positioning the company for the future. Combined with a slow-growth economy, uncertainty around tax, trade, and infrastructure policies, and geopolitical tensions at precarious levels, the year ahead will require a careful balance of near-term focus, agility, and long-term thinking.

Drawing on insights from our conversations with board chairs, board members and company secretaries over the past twelve months, we have highlighted ten issues that, in our opinion, boards should keep in mind as they approach and execute their 2018 agendas:

1. Long term value creation and the company's role in society: The context for corporate performance is changing, and consideration of the corporation's role in society is moving from the periphery to the centre of corporate thinking. Investors, customers, employees, and other stakeholders are sharpening their focus on how companies approach social and environmental issues. Companies are increasingly recognising that societal issues - from sustainability of natural resources, to a 'responsible' tax strategy, to a more diverse talent pool - have real implications for the company's long–term performance, strategy and risk profile. Does the board have sight of the company's impact on society and the threats that can damage the company's reputation? What steps is the company taking to address any negative environmental or social impacts that it is creating or causing? Is the company on the front-foot, or is it passive or even resistive in responding to societal expectations? Are there environmental and sustainability–related opportunities that would help drive the company's long–term performance? Are the company's activities in this area (both results and ongoing efforts) effectively communicated to its shareholders and other stakeholders?

   Think about how the board balances the often competing interests of different stakeholder groups and specifically the board's duty to create long-term shareholder value with wider societal purpose. How does the board exercise regard to the broader group of stakeholders in its decision making? How does the board better understand the issues faced by its various stakeholders – does it employ worker directors, stakeholder advisory panels or task individual non-executive directors with specific responsibility for certain stakeholders? How does the board balance the conflict between long-term and short-term perspectives? How will the board report to an ever more active stakeholder base (including regulators and the media)?

2. Connecting strategy and risk: Connecting and calibrating strategy and risk is more important - and more challenging - than ever. 2016's EU Referendum and US Election have major implications for global markets and the geopolitical landscape at large, yet they caught many observers and corporate strategies flat–footed. That so few had predicted these sea changes despite exhaustive analysis in the run–up to both events is a stark reminder to businesses of how marketplace signals can be fundamentally missed (be it status quo thinking, bias toward the familiar, or comfortable

complacency) and the playing field fundamentally altered overnight. The policy landscape will become clearer, but expect the competitive landscape to remain dynamic and opaque, leaving little lead time.

Advances in technology and relentless innovation, business model disruption, the emergence of Millennials and other demographic shifts, evolving customer demands and employee expectations, and more, will put a premium on corporate agility and the ability to react as conditions change. Think about constant transformation, talent risk management and the opportunities afforded by 'new' technology. Does management have an effective process to monitor changes in the external environment and test the continuing validity of strategic and risk assumptions? Is the board confident in its ability to evaluate competitive threats and understand emerging and potentially disruptive technologies? Does the risk management process provide early warning that adjustments may be necessary? Does the board have the right people and perspectives to make the necessary linkages between external forces and the company's strategy and risk profile? Is strategy an ongoing discussion (versus an annual decision) that incorporates smart risk-taking and robust scenario planning with plenty of 'what - if's' on the table? In short, 'strategy and risk' should be hardwired together and built into every boardroom discussion.

3. Geopolitics: Brexit, the refugee crisis, conflict in the Middle East, the unpredictability of Russian foreign policy, increasing tension with North Korea, and China's economic sluggishness are just some of the issues shaping the geopolitical landscape. While some of these global issues are generating more traditional geopolitical risks, events such as the massive demographic shift created by the refugee crisis - and the pressures that they are creating in Europe for business and society alike - are different. Even though China's economy is growing faster than the rest of the world, international stock markets came to a virtual standstill when China's market dropped, significantly resetting global trade dynamics. Factor in the enormous uncertainty following the EU referendum and the US election and its clear geopolitical instability needs to remain high on the board's radar. Does the board understand the company's geopolitical risk exposures?

   For some industries, it is tempting, but dangerous, to put the intrinsic question of geopolitical risk on the back burner. Boards at oil and gas and mining companies are already dealing with large-scale disruption of the economic and financial models they rely on. These organisations are focusing on issues such as financing, impairments and cost reduction initiatives. However, cost and headcount reductions can have significant impacts that companies may not always foresee. Control frameworks, for example, may be impacted as the individuals tasked with executing on them may have changed positions or left the company. Boards should make sure they understand these potential impacts and are comfortable that remedial measures are in place.

   Companies are looking to access emerging markets, but the question of how to play in those markets and what risks they raise is key. It's important to balance your exposure in good and bad times and given current economic challenges, boards will want to consider their company's new market entry plans very carefully. How will management mitigate new risks? Do they fully understand them? How effective are existing controls? Are more controls needed? And if the company already operates in volatile markets, should a review of risk management in those jurisdictions be undertaken?

4. Innovation: Advances in digitisation, robotics, and Artificial Intelligence (AI) continue to threaten established business models and put pressure on boards to stay ahead of both existing and emerging competitors. Understanding technology as an enabler of growth – and devising a strategy to deliver it – is therefore a key factor for most boards.

   When an organisation effectively implements an industry changing technological innovation, one major effect is that their competitors' business models - and possibly a business model that has been an industry standard - can be disrupted. Consider the effect that ride sharing has had on the way the taxi industry has been operating for decades, or how internet-based streaming services have changed the way television is purchased and consumed. Is the board paying attention to how, and which, disruptive technologies could potentially put the organisation's business model at risk? Will the company outsmart, outpace and outmanoeuvre the competition by embracing innovation, or will they be marginalised? Look to understand the behaviours and expectations of customers and employees (and regulators). Are management regularly meeting with stakeholders to explore how their challenges might be met by technological and innovative solutions?

   Think about 'big data' and how it can be used to deliver more meaningful insights into the boardroom. Think about cyber security (see below) and the potential risks around remote working, Bring Your Own Devices (BYOD) and cloud computing; but also explore the opportunities afforded by robotics, AI, nanotechnologies and other disruptive and emerging technologies.

5. Talent management and inclusion: Ask any board what makes their company different and the majority will say it's their people. Recruiting and training a great workforce takes time and focus. Boards have an important role to play in ensuring senior executives stay focused on building the right talent strategy, preparing for generational transitions and the different aspirations of Millennials, and anticipating the changing dynamics across the board, management and wider workforce. Does the board think as deeply about human capital as it does financial capital?

   Having the right people to execute on strategy is essential for success, so disruptive forces like Brexit and advancements in technology provide opportunities to rethink the workforce in a new light. Closing the book on new hires and staff training may seem sensible in uncertain times, but a failure to develop and nurture people talent risks jeopardising future opportunities.

   Is there clarity over the board's responsibility with respect to talent management? Has the board given thought to diversity and inclusion in terms of gender, race, experience, age, disability and outlook? Is there a programme f or identifying, developing and promoting t alent?What steps are being taken to grow future t alent and manage in the light of globalisation and technical innovation? With more flexible working arrangements and hiring contractors over employees, boards need to make sure executive leadership are taking appropriate steps to ensure the management are trained in managing virtual teams.

6. Cybersecurity: Refine and widen boardroom discussions about cyber risk and security. Despite the intensifying focus on cyber security, the threat to data confidentiality, integrity and availability of systems remains high. As such, board oversight must continue to evolve in line with the changing cyber landscape.

   Discussions are shifting from prevention to an emphasis on detection and containment, and increasingly focused on the company's 'adjacencies' which can serve as entry points for hackers. The Internet of Things and the digital records that surround people,organisations, processes, and products call for deeper - if not wholly different - conversations. The board should help elevate the company's cyber risk mind-set to an enterprise level, encompassing key business leaders, and help ensure that cyber risk is managed as a business or enterprise risk - not simply an IT risk. Do discussions about M&A, product development, expansion into new geographies, and relationships with employees, suppliers, customers, partners, advisers, and other third parties factor in cyber risk?

   Help ensure that awareness of, and accountability for, cyber security permeates the organisation, with a security mind-set, proper training, and preparation for incident response. Is cyber security risk given regular and adequate time on the board's agenda? Where does accountability and responsibility for cyber security lie? Does the board need a separate committee to focus on it?

   Where are the company's biggest vulnerabilities and how is the company protecting its most critical data sets? Does the company benchmark itself against others in the industry and learn from high profile situations that other companies have faced? Does the company understand the company's third party relationships, and the controls that exist around those with access to the company's proprietary data? Has the company explored its involvement in industry-wide alliances, where companies and other agencies can work together to detect and combat cyber-crime? Does the company have a cyber security scorecard and a robust cyber incident response plan? Is the plan rehearsed and are the scenarios up to date? Do directors know the number and nature of policy breaches in the last period, and the consequences both for the company and individuals; and do they work under the assumption that any email could become public at any time?

7. Boardroom composition: Take a hard look at the board's composition: Is the talent in the boardroom aligned with the company's strategy and future needs? Given the demands of today's business and risk environment, aligning boardroom talent with company strategy - both for the short–term and the long–term as the strategy evolves - should be a priority. Not surprisingly, forty-three percent of respondents in our pulse survey, Building a great board, cited 'resistance to change' and 'status–quo thinking' as hampering their board–building efforts. Whether it's addressing a gap around technology or finding people who have international experience, talent needs to be part of the strategy discussion.

Boardroom composition and succession should start with clarity over the company strategy and a clear view of the needs of the business over a range of time horizons, closely followed by an examination of the skills gaps in relation to those needs. Before developing plans for long- term succession, consider using skills matrices to identify current and future skills gaps and think about the time requirements, on-boarding, the role of ongoing professional development and the output from the annual board evaluation exercise.Think about both 'business as usual' and emergency scenarios.

Be cognizant that boards and nomination committees are now in the firing line with investors, proxy advisors and the media looking to hold directors to account for a wide range of issues including board diversity, succession planning, independence, tenure, over-boarding and disclosure. In an environment where company directors face annual election, institutional investors are increasingly using targeted voting practices to register their displeasure at particular governance practices – whether that be voting against the re-election of the remuneration committee chair to register a perceived unwillingness to change executive pay arrangements or against the audit committee chair in the light of accounting irregularities, or a failure to adhere to perceived best practice. In particular, expect proxy agencies to recommend voting against the nomination committee chair where: the roles of the chief executive and chair have not been split; where a senior independent director has not been appointed; where the board has not conducted an external evaluation of its effectiveness within the past three years; or where an individual who has a significant conflict of interest, or whose past actions demonstrated a lack of integrity or inability to represent shareholder interests is nominated (or re-nominated) to the board. For more issues on the Nomination Committee Agenda please see 'On the 2018 Nomination Committee Agenda'

8. Corporate culture: Pay particular attention to potential risks posed by tone at the top, culture, and incentives. The adage that "culture eats strategy for breakfast" has perhaps never been more relevant as companies and their boards navigate an increasingly complex global business environment fraught with pitfalls and pressures and rich with opportunities. Corporate culture - what a company does, and how it does it - permeates virtually every aspect of an company, from strategy, innovation, risk, and compliance, to business processes, employee performance, and long- term value creation.

    And, as many companies have experienced (or will) first-hand, the radical transparency enabled by social media and the ever-sharpening focus by customers, employees, investors, regulators, and other stakeholders has put culture on display as never before.

    It's clear that corporate culture continues to climb higher on board agendas - not only as a risk, but as a fundamental driver of long-term performance. Yet, assessing and monitoring the company's culture pose formidable challenges. Do the company's stated values represent the actual culture of the company - the "unwritten rules"? Does the culture align with the company's strategy and encourage behaviours that are essential to the execution of that strategy? Is the board continually gauging not only tone at the top, but the mood in the middle and the buzz at the bottom?

9. Shareholder engagement: Shareholder engagement is rapidly becoming a priority for companies as institutional investors increasingly hold boards accountable for both company performance and upholding governance standards, and demand greater transparency, including direct engagement with independent directors. They are asking tough questions and want to understand the board's role in strategy and risk as well as understanding whether boards are robustly evaluating their own effectiveness.

    Institutional investors expect to engage with portfolio companies – especially where investors have governance concerns or where engagement is needed to make a more fully informed investment and/or voting decisions. In some cases, investors are calling for engagement with independent directors. As a result, boards should periodically obtain updates from management about its engagement practices: Do we know and engage with our largest shareholders and understand their priorities? Do we have the right people on the engagement team? What is the board's position on meeting with investors? Which of the independent directors should be involved? Strategy, executive compensation, management performance, environmental and sustainability initiatives, and board composition and performance are likely to be on investors' radar.

    Be mindful of shareholder concerns and the company's vulnerabilities to activist investors by proactively engaging with shareholders, addressing their concerns.

Activism need not be short-term nor undermine the board's strategic thinking – if done properly, it can help focus the strategy and drive enhanced corporate governance. Does the board understand investor views? Is the company prepared to respond to activist intervention? Play the role of activists by looking at the company from the outside-in and prompting change from within to benefit shareholders.

10. Regulation: Businesses are used to the increasing burden of regulation. Some may hope that the UK's departure from the EU and the new US administration may herald reduced regulation, most would accept that greater regulation will be an on-going trend. Whether moving quickly to innovate and capitalise on opportunities in new markets, leveraging new technologies and data, and/or engaging with more vendors and third parties across longer and increasingly complex supply chains, most companies face heightened compliance risks. Coupled with the complex global regulatory environment - the array of new environmental, financial services, and data privacy regulations - these compliance risks and vulnerabilities will require vigilance.
As a result of the radical transparency enabled by social media, the company's culture and values, commitment to integrity and legal compliance, and its brand reputation are on display as never before. Help ensure that the company's regulatory compliance and monitoring programmes are up–to–date and cover all vendors in the global supply chain, and clearly communicate the company's expectations for high ethical standards.

Take a fresh look at the effectiveness of the company's whistleblower programme – a common theme running through a number of recent scandals is that employees alleged that they communicated concerns, but that their concerns were ignored. Does the board receive regular reports on whistleblower complaints and how these were addressed? What is the process used to filter complaints that are ultimately reported to the board and/or audit committee?

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