



With board members facing continued political, economic and technological disruption, they are unlikely to enjoy a quiet year. *Ken Arthur* outlines 10 priority issues that should be high on the agenda of boards and audit committees in 2018.

**The corporate world** will inevitably continue to experience a high level of disruption in 2018, providing board members and audit committees with a range of issues to deal with. One thing is certain: inaction is not an option.

Globally, businesses face varied threats, from escalating tensions in the Middle East to the continued uncertainty in Europe as the UK negotiates its exit from the European Union (EU), and from the increasingly complex relationship between the US and Russia to security concerns raised by North Korea.

One issue facing all companies is how to exploit digital technology. Digital is the engine of both opportunity – opening up new markets and potential new business models – and challenge, fueling disruption in every area of the business and threatening established models and methods.

Other forms of disruption that will directly affect businesses include a growing sense of unease about corporate behavior, and regulators that are under increasing pressure to develop frameworks to foster growth, but curb short-termism and unfair practices.

In order to reflect these dynamics, EY has defined 10 areas that boards and audit committees should be prioritizing over the coming year.

### **1) DEVELOPING LONG-TERM VALUE AND CORPORATE PURPOSE**

In 2017, some of the largest institutional investors in the US (the Investor Stewardship Group) issued a voluntary corporate governance code for US-listed companies, intended to support collaborative investor and company efforts to create long-term value. Boards worldwide are increasingly under pressure to articulate

long-term plans to demonstrate an understanding of the underlying and urgent trends affecting their businesses, ranging from energy use and employee satisfaction to value creation and diversity.

In the past, boards enjoyed far more power over the company's narrative; they could choose which parts of the story to emphasize. But with greater access to information, investors are increasingly prepared to make their own judgments.

Given these trends, there are three key questions for boards to consider:

- ▶ How is digital disruption affecting the business model?
- ▶ How are stakeholders assessing the value the organization delivers for them?
- ▶ Are the board and the stakeholders clear on corporate purpose?

Failure to engage with these questions could represent a genuine threat. Politicians across the world are expressing concern about perceived corporate misbehavior and, for many, legislation is the next step. For boards, there is little time to waste in developing and articulating an adequate response.

## 2) INTERACTING WITH SHAREHOLDERS

Efforts toward giving shareholders more of a voice in corporate strategy have been gathering pace for some time. Regulators across the world have been urging companies to increase the amount and clarity of their disclosures to shareholders, with mixed results. The introduction last year of the Shareholder Rights Directive (SRD) in the EU was a response to the slow rate of progress under voluntary codes.

Regulators have recognized that major investors increasingly take a long-term view. As such, there is a

growing need to align long-term assets and liabilities. Some jurisdictions have already moved to improve transparency around directors' remuneration, for instance. And under the SRD, European companies must now demonstrate a clear link between corporate performance and executive pay.

The SRD presents boards with an opportunity to improve the alignment between corporate strategy and shareholders. They will be expected to develop policies that take account of stakeholder feedback and will then be subject to shareholder approval and oversight.

## 3) FOCUSING ON CORPORATE REPORTING

The reporting landscape continues to change and boards must now take a proactive approach to communicating with stakeholders. Indeed, the International Accounting Standards Board has launched a project on the quality and effectiveness of financial reporting under IFRS, with the umbrella title of "Better Communication."

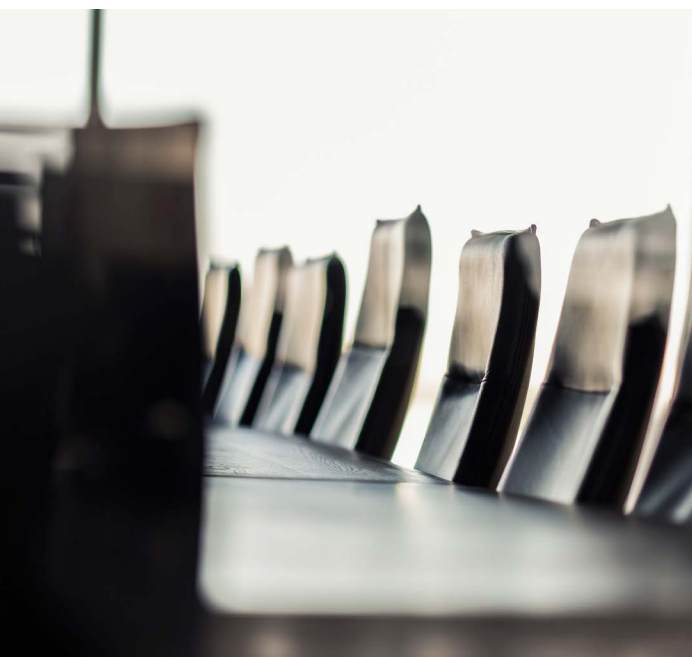
Preparers of corporate reports must ensure that they are putting historical performance into context as well as presenting the risks, opportunities and prospects for the company in the future. The

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primary purpose will be to help investors and stakeholders understand the company's strategic objectives and the progress made in the execution. That means delivering a clear and consistent sustainable value-creation strategy. It also means that there must be coherence between financial performance measures and other performance indicators. Finally, it means that reports must establish a clear link between strategy, key value drivers and executive remuneration structure.

Of course, long-term value creation is not entirely sustained by financial growth. Nonfinancial measures have gained currency as sustainability concerns, risk reporting and scrutiny of corporate governance have become more important. In particular, the ongoing work of the [Task Force on Climate-related Financial Disclosures](#) will require boards to integrate climate risk into their corporate reports.

In the wake of these consultations, stakeholders will expect to see boards demonstrating that they have assessed their exposure to such risks. That will also extend to greater transparency in areas as diverse as bribery, human slavery and energy use.





#### 4) OPTIMIZING CAPITAL ALLOCATION DECISIONS

The role of the board in capital allocation has been the subject of debate in recent years. There are varied views on what directors should be doing in terms of setting strategy, providing oversight and measuring success.

However, it is certainly true that stakeholders now expect directors to take an active role in developing long-term strategies to grow the company's business. Taking on questions of opportunity and risk management is of utmost importance, especially while businesses continue to experience digital disruption.

Given this, the board must become a "constructive challenger" of the capital allocation strategy. By

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maintaining a healthy distance from everyday operations and having a diverse composition, it should be able to challenge the status quo by asking the right questions.

As new megatrends gather pace, from autonomous vehicles to artificial intelligence, are boards prepared to assess where capital investments should be allocated? Are executives suitably empowered to make informed decisions? Are the right external advisers engaged at board level? Are key stakeholders on board with the company's strategy?

#### 5) ENHANCING TALENT AND CORPORATE CULTURE

Boards have a critical role to play in developing a healthy corporate culture built on trust, innovation and flexibility. Stakeholders increasingly expect to see boards recognizing the value of a diverse workforce and innovative thinking. That expectation extends to the board itself.

The links between diversity – at boardroom level and beyond – and better corporate performance are growing in strength and number. Diversity does not simply mean ensuring a balance of ethnicities and gender in the workplace. It also requires boards to seek out and champion a diverse set of voices from a range of educational and cultural backgrounds. By doing so, companies should develop a more innovative and engaged workforce.

Increasingly, external stakeholders expect talent issues to be measured and reported on. From basic KPIs such as employee turnover to more sophisticated qualitative analysis tracking staff engagement and productivity, businesses are now expected to monitor how their culture is affecting performance.

#### 6) DEFINING REWARD

The increased scrutiny over the creation of sustainable long-term value is bringing executive pay into the center of corporate culture and reporting. Stakeholders now have greater powers to demand more transparency and oversight of executive remuneration.

For companies in EU Member States, a new era is about to begin. The biggest change will be the introduction of an annual vote on the compensation report. Boards will be required to defend their remuneration reports and policies and, if there are votes against the board's recommendation, they will have to explain at the next AGM how they have incorporated this into their decision-making.

This will require real board engagement in new areas, such as pay ratios that contrast executive pay

with others within the organization. If these ratios, as well as a perceived misalignment of performance and reward, continue to cause concern at national level, then boards should be prepared for further legislation in the coming years.

Stakeholders will be able to exert greater influence over this by demanding that boards create a set of KPIs that feed into remuneration strategy. This should drive improved and more transparent behavior at board level. It will be up to boards to demonstrate their commitment to this.

## 7) STRENGTHENING PARTNERSHIPS AND GOVERNING RISK

Understanding and managing third-party risk has become a corporate priority because of greater oversight from regulators. In addition, increased numbers of stakeholders are now taking an active interest in how corporates run their supply chains, tax affairs, boardrooms and talent programs, and how they manage customer data.

Historically, a company's suppliers have managed their own risks, but greater integration of supply chains means that this is changing. Suppliers, partners and customers must all be considered part of the wider risk picture.

Cyber risk remains a key area. The closer integration of third parties and large multinational businesses is creating more access points and areas of vulnerability. In turn, this creates greater risk that unwanted information may pass over from

the company to the third party. The General Data Protection Regulation (GDPR), which comes into effect in the EU in May 2018, will only add to the need for boards to bring third parties into the effort to secure data and manage it effectively.

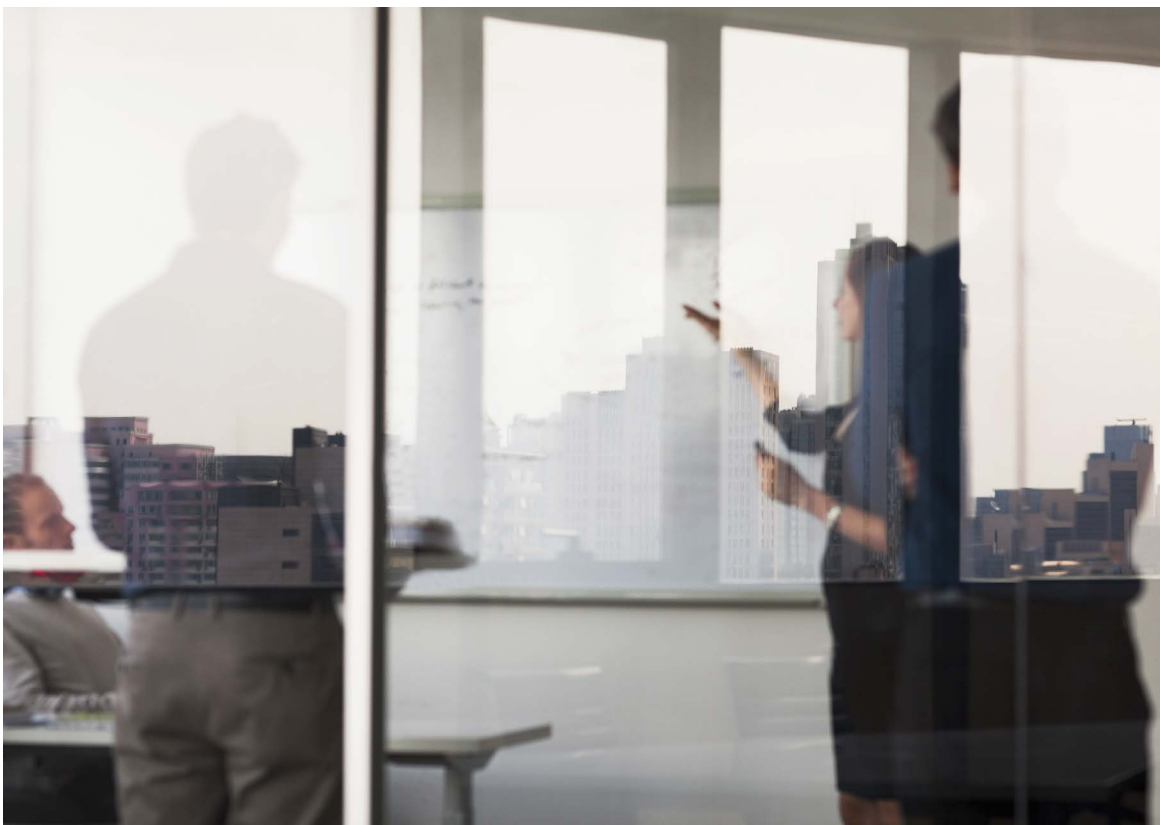
Boards must also grapple with a new challenge: how can they isolate mission-critical information within the organization, while maintaining integrated and efficient operations? Managing financial data, trade secrets and commercially sensitive material must now take into account third-party exposure.

The expectation from shareholders and regulators is that boards must know exactly what the company is doing across the globe; which third parties are acting on their behalf and what they are authorized to do. Boards are increasingly exposed if any inappropriate or criminal behavior takes place that jeopardizes the interests of the organization.

## 8) MANAGING CYBER RISK – A NEW ERA OF SECURITY

In the wake of recent high-profile cyber breaches, boards can no longer afford to leave the management of cyber risk to the technical functions. They will have to empower their management leaders to design and implement proportionate risk management strategies.

Internal audit will have an important role to play here, but may need to be augmented with external





expertise to provide tech assurance. Regular cyber risk assessments must become routine.

The GDPR will increase pressure on boards to reach best practice in how they process and manage data. The penalties for compliance failures have increased considerably. In addition, the Network and Information Security Directive (NISD) will require EU Member States to develop their own cyber strategies for the public and private sectors.

The focus of any efficient strategy will follow a simple mantra: “sense, resist, react.” This requires systems that are sensitive to any attack and robust enough to withstand it, and that any breach can be minimized and normal service restored quickly.

Boards must also be prepared to look outside their organization to stay abreast of the latest developments. Non-executive directors can help by bringing a broader industry perspective to how peer companies are handling this risk.

In addition, stakeholders increasingly expect to see boards take a proactive approach, and effecting cultural change must be a priority. People are simultaneously the weakest link in the chain and an organization’s strongest asset in this area. HR policies must promote awareness and encourage vigilance at all times.

## 9) REFLECTING NEW RESPONSIBILITIES FOR AUDIT COMMITTEES

The audit committee has always played a pivotal role in corporate governance, and changes to EU audit legislation in 2016 have seen it assume even greater importance in promoting confidence in the audit.

The key change centers on the audit committee’s responsibility for the appointment of the external auditor, which was previously a management board decision with some input from the audit committee. This means that, for the first time, the committee must have the skills to assess the performance of their current auditor and the quality of the audit, as well as identifying buying criteria for future tenders.

The new regime also requires the audit committee to recommend two audit firms for appointment, expressing a preference for one. This demands a comparative assessment. To do this, the committee will have to assess not only technical competence, but also softer factors such as working relationship, the character of the team and the sector expertise each auditor offers.

Ensuring a competitive tender process requires advance planning because of the interrelationship between tendering timetables and non-audit services restrictions. This will require audit committees in particular to have a good understanding of how professional services are procured across the group; which firms are providing what, where; how those engagements are structured; and how long they may take to unwind.

There are also other changes that the audit committee needs to consider. These include strategic disruption and the future sustainability of the business model; the digitization and automation of the finance function; new demands on external reporting; new performance metrics where digitization will be key; and, finally, how auditors are using technology to increase audit quality, drive efficiency and provide greater insight.

## 10) CREATING BOARDS OF THE FUTURE

Boardrooms are beginning to change. In 2018, that will continue as the diversity agenda takes center stage. This agenda now extends beyond simple compliance with gender or ethnicity guidelines; stakeholders want to be sure that boards have the right blend of different skills, voices and backgrounds.

For instance, adding digital competency to the board will inevitably change its composition as newer members bring fresh ideas and a new approach to hierarchy, dissent and challenge. Cultural leadership behavior will change as discussions become more open, with less dominance granted to seniority and experience.

Experience, as expressed at board level, will also acquire new value: the experience of questioning

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traditional methods and strategies. In short, boards will need to be prepared for more challenges, not only from non-executives, but also from executives: the successful directors will have the determination and confidence to ask the right questions.

The direction of travel is for more transparency in the makeup of boards. That extends beyond the background and connections of directors; it means showing stakeholders that the board is serious about anticipating and planning for the business’s future needs, and about mitigating future risk. ■

*This is an edited version of an article that first appeared on the EY Center for Board Matters: Board agenda 2018: [Top priorities for European boards](#). See also [Top priorities for US boards in 2018](#).*

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