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Insights for boards and audit committees

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In this issue

The pace of change unleashed by technological disruption is unprecedented, even as it opens new opportunities to businesses across industries. This edition of the BoardMatters Quarterly highlights some of the most pertinent aspects of technology disruption – how boards can equip themselves to keep pace with changing technologies and new business models, intelligent automation and the digital workforce where humans and robots work together and the growing cyber risks for organizations as they operate in a digital world. The edition also includes an article on integrated reporting, following SEBI's announcement towards its voluntary adoption

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Chairman, Bank of Baroda, and Independent Director, Infosys

Are board directors ready for technology disruption?

Ravi Venkatesan elaborates on the role that boards should play in this age of technology disruption. He also shares how board directors can equip themselves to ride this new wave of change.

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The next wave of intelligent automation (IA) is set to have a profound impact on the workforce – ranging from significant job creation to job displacement, and from increased labour productivity to widening skill gaps. The article emphasises how board members and C-suite executives need to embrace the change, identify the best talent and empower other senior executives to adopt the best systems and technologies for their business and integrate technology into the workplace.

06 **Cyber preparedness for boards**

The recent wave of security breaches proves beyond doubt that all companies today stand to risk their competitive advantage and shareholder value, as well as their reputation. Hence, cyber resilience has emerged as a critical boardroom imperative. The article highlights how organizations need to learn to defend themselves and respond better, moving from basic measures and ad hoc responses to sophisticated, robust and formal processes.

08 **Integrated reporting: A new approach to company disclosures**

Subsequent to SEBI encouraging listed companies to voluntarily adopt the integrated reporting framework in the coming fiscal, this article highlights the need for an integrated reporting framework and the key components that form part of it.

Intelligent automation and the digital workforce: how to get on-board with change?

Milan Sheth, Partner - Advisory Services and Technology Sector Leader, EY India

Technology has allowed organizations to make quantum improvements in operational performance and customer experience. However, disruptive changes to business models have had a profound impact on the employment landscape — ranging from significant job creation to job displacement, and from increased labor productivity to widening skills gaps.

Now, the next wave of intelligent automation (IA) is creating a new organizational model that augments digital capabilities, leverages robotics process automation and rethinks processing with the help of artificial intelligence (AI). This is poised to accentuate the issue of labor displacement. The IA revolution is driving an unprecedented reinvention of the workforce, which no longer is a reference to people alone. Instead, as part of the digital workforce, people and bots are working together to reimagine processes end-to-end, which impact several factors simultaneously - efficiency, quality, customer satisfaction and profitability.

Board members and C-suite executives need to embrace this change, identify the best talent and empower other senior executives and the rest of the organization to adopt the best systems and technologies for their business, integrate technology into workplace processes and adopt an open, collaborative culture while reskilling the workforce.

Organizations are combining strong digital capabilities, robust IA adoption and a digital workforce management strategy to achieve significant benefits

To begin with, IA was primarily used in manufacturing processes and later in other functions, albeit only partially. But now, it is increasingly becoming an integral part of various enterprise functions such as finance, HR and supply chain. Organizations are putting in place a comprehensive IA strategy to enable enterprise-wide transformation. Organizations adopting IA at scale or in a core part of their business can already see the technology's potential, and those implementing proactive IA strategies are anticipating even greater benefits.

For instance, a leading global e-commerce company achieved impressive results by automating its picking and packing functions. Its "click to ship" cycle time, which ranged from 60 to 75 minutes with humans, decreased to 15 minutes, while inventory capacity increased by 50% and operating costs decreased an estimated 20% [1]. A leading internet television network is using an algorithm to personalize recommendations for its 100 million subscribers worldwide. Helping viewers quickly find desirable content is critical as viewers tend to give up if it takes longer than 90 seconds to find a movie or TV show they want to

1 "Amazon's $775 million deal for robotics company Kiva is starting to look really smart," Business Insider, http://www.businessinsider.in/Amazons-775-million-deal-for-robotics-company-Kiva-is-starting-to-look-really-smart/articleshow/52771614.cms, accessed 24 August 2017.

watch. Through better search results, the company estimates that it is avoiding cancelled subscriptions that could reduce its revenue by US$1 billion annually. [2]

The board's role as an IA evangelist

IA is often pigeonholed as an IT topic, but it is not. To be successful, IA adoption requires sponsorship of the executive suite to generate the momentum needed to overcome organizational inertia. Successful IA adopters have strong executive leadership support. As IA enables transition to a "services-based customer-oriented" business, all C-level executives will need to drive this change. The chief financial officer, chief human resources officer, chief operating officer and chief marketing officer must adapt, as the impact will be felt across finance, people, production, sales and marketing.

Strong support is needed not only from the C-level and IT executives (chief information officer, chief digital officer, and chief technology officer), but also from the board of directors. Board directors can add significant value by focusing their conversations and available resources to bring expertise, teaching, coaching and ideas to the leaders. Similarly, organizational leaders should proactively ask board members to help drive IA, as well as tap into their expertise and extensive boardroom experience and networks.

Points to consider for the board

As a board member, what would be your advice to organizations contemplating to commence their IA journey? Topics to discuss with the management might include the following:

- **Decide what you want to achieve with IA:** The first step is to establish a solid IA business case and connect it to the organization's strategy. Subsequently, identify the AI technologies that will bring the most benefits and then start developing the infrastructure, talent and skills as early as possible to catch up on the learning and adoption curves.
- **Adopt an open culture and reskill the workforce:** The advent of virtual robotics workforce will drive transformation in workforce management policies. Automation requires a change in the leadership style from purely people leadership to thinking about how to manage bots as well. It also requires investment in building the capabilities of workers, especially mid-level managers, to enable them to understand how to leverage data-driven AI insights and to trust them as the basis for making decisions.
- **Ensure you are comfortable with technology:** As organizations automate extensively, their dependence on technology becomes almost absolute and they need to be aware of and plan for this change. Organizations have to be comfortable with technology and need to manage the overall flow and not just individual automation.
- **Enable a robust governance framework:** Lack of a governance framework can lead to ineffective and inefficient implementation, adversely impacting business processes and the ability to achieve business objectives.

IA is more than the sum of its parts — the change is not piecemeal but a complete metamorphosis when implemented across the value chain. It can permeate and drive value across every aspect of the business and the board. Organizations that do so will thrive in the new world, and those that do not, sooner or later, will struggle.

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2 "Why Netflix thinks its personalized recommendation engine is worth $1 billion per year," Business Insider, http://www.businessinsider.in/Why-Netflix-thinks-its-personalized-recommendation-engine-is-worth-1-billion-per-year/articleshow/52754724.cms, accessed 24 August 2017.

Are board directors ready for technology disruption?

Interview

Ravi Venkatesan

Ravi Venkatesan is Chairman, Bank of Baroda, and Independent Director, Infosys. He is also Founder Chairman of Social Venture Partners and serves on the Board of the Rockefeller Foundation. Ravi has authored the book *"Conquering the Chaos - Win In India, Win Everywhere."*

He has been Chairman of Microsoft India and Cummins India. He has also been on the boards of Harvard Business School, AB Volvo, Thermax and Bunge.

Q. What role can boards play in these times of technology disruption and how do board prepare for this transition?

Today, you can either be a disruptors or disrupted, and organizations have to decide where they would rather be. The role of the board has to change from being more than just compliance. The board has to educate itself about what is happening in the industry and what competition is doing, which goes beyond just traditional competitors. This means not relying on the perspective of management alone but seeking outside perspectives. They need to ask whether the CEO and the management team are aware of these trends and working toward making these changes a tailwind or have they become a headwind.

It is the board chair who must take the responsibility to ensure that directors are devoting time to learning. I don't know many companies that insist that boards and directors take courses. Not just courses on board effectiveness and how audit committees work but learning about business and how things are changing. Boards also need to invite analysts, consultants and customers to hear from them and have an honest and intense debate on how the company is positioned.

> **In a rapidly changing market, you need a culture of experimentation.**

Q. You have often said that the right culture is necessary to ride disruption. What can the board do vis-à-vis culture?

The board must ask if the organization has the right leader as there is a difference between peacetime and wartime generals. In a rapidly changing market, you need a culture of experimentation. That is very different from the way established businesses run, which focus on operational efficiency and compliance. To be able to keep up with new-age businesses that are always experimenting and taking risks, the culture must move in that direction.

The important thing to remember about culture is that while being the biggest strength, it is equally the biggest inhibiter of change. For most successful organizations, there is an incredible alignment of their business model with the market and their processes, systems, culture and leadership. When you try to shift the strategy, this

alignment gets disturbed and from being a strength, culture becomes a "core rigidity" and a barrier to change. There are several examples of large organizations that as they begun to change were prevented by the softer factors to move at the speed which was needed. Therefore, the biggest skill of the leader is to manage the cultural shift.

Q. How does one walk the tightrope of meeting quarterly expectations and not losing sight of disruptive changes in the environment?

If you do not explain to investors about the transformation opportunity, they will always measure you quarter by quarter. What CEOs and CFOs need to do is change the narrative and calibrate expectations, something that boards need to be willing to support. At the same time, we have to recognize that patience will die very quickly if you do not have some balance between long term and short term performance.

Today, you have to have a part of the organization that is managing the existing business and delivering predictably against stronger and stronger headwinds, but also create a new team that is razor-focused on building future-focused businesses. You have to aggressively move talent and investments to the new business and also set a roadmap and milestones and show how you are progressing.

I think the hardest thing is to create two teams – for the new and the legacy businesses. They require different talent and cultures. You have to contain these two very different organizations and manage the tensions well, and also take your stakeholders along, be it your employees, board, shareholders, the media and the public at large. It is not easy and needs an extraordinary leader.

Q. What are the key risks one needs to be aware of when embarking on a digital transformation?

The biggest risks are that you destabilize what was working, and the new businesses do not take off. The challenge is when you end up with hostility between different parts of the organization. Emotions need to be handled well as these are issues of power, influence and identity. Another risk is the lack of agility for

> **"You need board members who are strong domain experts and understand the industry. You need a board that is diverse not just in gender terms, but reflects the diversity of the customer base, whether geographically or in terms of sector.**

course correction. Successful start-ups are nimble and experiment until they find their way to success, but big companies are much slower and that is a risk in terms of managing stakeholder expectations. I have seen this work better where there is a significant promoter shareholding and alignment with the CEO's vision as against a more diffused shareholding, structure.

Q. Is there a need to rethink board composition in this era of technological disruption?

Absolutely. It is no longer about ticking the box and saying we need a lawyer, a CA etc as that worked in a generally stable environment. Now, you need board members who are strong domain experts and understand the industry. You need a board that is diverse not just in gender terms, but reflects the diversity of the customer base, whether geographically or in terms of sector. You also need one or even two people who are smart about technology as every business today is a technology business, or someone who has experience in driving transformational change.

One way of doing this is to expand the board and shift the conversation. Another way is to create advisory committees with relevant external experts, who work closely with board directors. You need to be innovative with the structures to access the expertise needed for boards to play their new role.

Cyber preparedness for boards

Burgess Cooper, Partner - Cyber Security, Advisory Services, EY India

News headlines of the ‘WannaCry’ ransomware attack in many countries have brought cyber risks back into the spotlight. This global incident underscored, once again, the fact that cybercriminals have emerged from being a fringe to becoming an ever-present threat for both the corporate and the government sector.

Ransomware explained: Bringing cyber risk into the spotlight

Ransomware is exactly what it sounds like: Malware used by cyber attackers who demand a ransom to restore the data or service it threatens. Some ransomware is capable of encrypting 100,000 files in under 2 minutes. When the WannaCry incident began, it spread quickly to 230,000 systems in over 150 countries. Typically, malware tends to rapidly spread to individuals and businesses, making it one of the major threats in today’s IT world. Ransomware attacks are a reality, and they are happening more and more often and affecting all organizations: The FBI estimates 4,000 ransom attacks per day.

“Locky” was the most deployed ransomware in 2016. It is distributed using spam emails containing an invoice. If the file is opened, the reader is asked to enable macros, which then leads to encryption of the file and closure of the system. A bitcoin ransom amount is then demanded to decrypt the data. Locky was responsible for more than US$500 million in losses in 2016.

These attacks can have a devastating impact on businesses. EY research indicates that only 42% of companies are able to recover their data fully from their backup systems. The actual ransom money paid is only a small portion of the total costs companies have to incur to overcome the damage that is done. The other costs that have to be factored include the response team, stabilization and restoration efforts, and enhancements to the cybersecurity framework to prevent future attacks.

Cyber preparedness: The next step for boards

Cybersecurity breaches are a growing problem for businesses around the world. A recent World Economic Forum report estimates that during 2017 to 2021, global cybersecurity spending will grow toward US$1 trillion, while at the same time the cost of cybercrimes will increase to US$6 trillion. According to EY’s Global Information Security Survey (GISS) 2016-2017, 87% of board members and C-level executives lack confidence in their organization’s level of cybersecurity.

Cyber security can no longer be viewed as an IT-only issue. While the CIO continues to play a crucial role in anticipating, identifying and managing cyber risk, the CFO and the board need to lead the discussion and embed an enterprise-wide risk appetite.

Clearly, with growing incidences of cyber breaches, businesses in India need to scale up their focus on cyber risks. Indian organizations are reluctant to invest in their cybersecurity architecture, despite 35% of those surveyed in GISS 2016-17, India Report, admitting to having had a significant cyber breach. Further, 32% of the organizations surveyed do not have an agreed-upon communication strategy in the event of a significant cyber-attack taking place, while only 38% are likely to communicate with their customers in the event of an attack affecting customer information.

These findings clearly point to a need for businesses in India to take a more engaged view of their preparedness for cyber security, as the pitfalls of not doing so can be devastating. As per the GISS 2016-17 India Report,

26% of Indian organizations incurred financial damage of up to US$100,000 in the past year. The preparedness levels of business as in India leaves enormous scope for taking substantial steps in this regard — for example, 55% organizations do not have, or have only an informal, threat intelligence program.

It is an area where the tone at the top, set by boards, can help bring about a transformative change in how threats emerging from an escalating cyber risk environment are addressed.

What boards need to keep in mind

Determine your risk appetite: Cyber risk cannot be completely mitigated. The reality is that every business will face cyber-attacks at some point, so it is important to establish a cyber risk appetite as part of the organization's overall risk management framework. What is your tolerance to cyber risk and how is that embedded across the organization? As initiatives progress around cloud, digitization and mobility, businesses need to ensure that an appropriate level of security is in place that aligns with the risk tolerance levels endorsed by the board.

Focus on protecting your critical assets: A better return on investment can be achieved by allocating capital to key areas of risk rather than taking a blanket approach across the entire organization. For this reason, boards should ensure investments are focused on the critical assets of the organization.

Critical assets may include M&A data, customer data, intellectual property, financial data or sensitive company information that may sway share price. Once identified, priority should be given to heavily protecting these assets.

Insist on receiving clear communication: Boards need to clearly understand the issues so that they know how much investment is needed and what initiatives should be prioritized. Information should be relayed in a clear business context. Lead and lag indicators as well as contextual information about the industry can assist boards in providing a clear picture of the current and future risks.

In particular, lead indicators focusing on governance and metrics can help identify how well issues are being managed today and provide valuable insight into the potential future-state risks.

Develop an enterprise-wide response to threats: Response to cyber-attacks should no longer be the responsibility of only the IT department. Businesses need to consider coordinating a response that involves all areas of the business, including media relations, investor and government relations, legal, operations, business, executive's risk and any material third parties. Modeling around scenarios should be tested and reported to the board, providing information on how well prepared the business is to respond to various types of cyber threats.

Focus on education and awareness: Cyber security is a shared responsibility. Cyber-attacks enabled by human error are a significant contributor to the overall risk which organizations face today, and this is something that cannot be addressed using technology alone. It is important that the entire organization and relevant third parties are aware of the cyber risks they may be exposed to in their everyday work life, and educated on how they should respond to these perceived risks.

Be clear about who owns cyber within your organization: While cyber is an enterprise-wide responsibility, it is essential to have a clear owner for cyber risk within the business. In many organizations, CFOs are increasingly becoming responsible for the overall cyber risk management strategy. This makes sense as CFOs may be best positioned to ensure key issues around metrics and reporting are reviewed in the overall business context.

Evaluate cyber insurance: Companies are increasingly investing in cyber insurance. While cyber insurance can be a valuable investment to protect against the impact of cyber incidents, it is essential for boards and the wider business to understand what is and is not covered. Businesses also need to ensure they have the evidence required to support claims that insurance providers are likely to require.

Do not discourage the use of new technology: Cyber risk should not be a reason to reject the deployment of new technologies. A better response is to learn how to deploy technologies securely, embed a culture around "security by design" and introduce clear business guidelines for their use.

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Integrated reporting: A new approach to company disclosures

On 6 February 2017, the Securities and Exchange Board of India (SEBI) released a circular advising the Top 500 listed entities in India to adhere to integrated reporting (IR) on a voluntary basis from the financial year to 31 March 2018.

This article elaborates on the concept and substance of IR, as also the factors that support the need for IR.

An increasing need from investors for more information

Over the past four decades, reporting has evolved in response to organizations' focus on addressing investors' demand for more information. However, despite this evolution, research indicates that investors believe disclosure shortfalls remain, especially in the reporting of strategy, risks and future performance. Also, non-financial information, which is often disclosed in different ways, is not easily comparable between organizations. The need for more information related to Environmental and Social Governance (ESG) was never in such demand earlier. A recent (March 2017) global investors' survey conducted by EY reveals the following:

- Investors around the world reveal broad support for the ESG-related themes expressed in the February 2016 memo from Laurence Fink, Chairman and CEO of BlackRock, to the leadership of the world's largest companies, calling for an annual board-approved strategy statement for public companies. Investors agree that ESG aspects present risks and opportunities that have been neglected for too long and also assert that sustainable returns require a sharper focus on corporate governance, environmental and social considerations.
- The importance of disclosure and scrutiny of non-financial information is set to grow in the years ahead. There is a growing belief among investors about recent environmental and social scandals driving a need to re-evaluate non-financial disclosures and the information already available.
- Investors believe the biggest motivator for companies to report ESG information is its potential to impact companies' reputation among their customers and regulators.

A new concept of value

Over time, the market value of organizations has slowly and gradually shifted from one that was based largely on tangible assets to one that puts a greater emphasis on intangible assets. This reflects a fundamental change in how value is being defined and perceived. Many progressive companies today have a market capitalization that is in multiples of the actual value that is reflected on their balance sheet. Having said that, investors and analysts continue to struggle to find a sustainable correlation between past performance, value reflected on the balance sheet, risks and opportunities, future prospects and the market capitalization of companies.

The genesis of IR

The global economic crisis that began in early 2008 severely impacted investor confidence, creating a need that saw the eventual setting up of the International Integrated Reporting Council (IIRC) in 2010, with a focus on improving the confidence of investors. The reporting framework that the IIRC created seeks to provide investors with information that is material to their decision making process. Ultimately, an integrated report should explain the reporting entity's interrelated financial, environmental, social and corporate governance information. It should be presented in a clear, concise, consistent and comparable manner. And disclosure should be retrospective and prospective to better match investors' needs. By doing so, organizations could improve their ability to access capital.

The key components of an integrated report

The business model: The definition of the business model lies at the heart of the integrated report. It defines the essence of the organization and maps out the processes by which sustainable value is created.

The multiple capitals model: A central tenet of IR is a belief that sustainable development requires a balance between economic progress, social advances and environmental protection. IR requires capturing the full contribution of all capitals to effectively demonstrate business performance. The IIRC has identified six forms of capital: Natural, social and relationship, human, intellectual, manufactured and financial. Prevailing accounting regulations seriously limit the ability to recognize internally generated intangible assets on the balance sheet. IR aims to track how the various capitals are used, how they relate to each other and the trade-offs the organization makes. The business model and strategy articulate how capitals will translate into value creation and can be measured by the use of key performance indicators.

Strategy and key performance indicators: The strategy is expected to describe the process and tools earmarked for value creation for shareholders and other key stakeholders, including customers, suppliers, employees and the society. The exercise also enables organizations to understand how to minimize negative externalities (externalities are an organization's impact, whether positive or negative, on capitals, including society as a whole) and maximize the positive ones. This could help shore up the value of an organization's intangible assets and, by extension, their performance. Integrated reports are expected to disclose the KPIs used by management to track performance. This helps investors compare organizations on their performance.

Risk and opportunity management: Effective risk management is crucial to ensuring the viability of the value creation process and achieving the strategic value creation targets. This requires incorporating risk management into the organization's decision-making process as well as strategy, while aligning it with prevailing industry circumstances. It seeks to reduce uncertainty about an organization's performance and future resilience. At the same time, it is also important to explain risk management processes in the integrated report as they are a clear contributor to the likely value in the long-term.

Materiality: A materiality assessment is crucial to ensuring that the report includes the factors that significantly impact value creation in the immediate term, and the performance over the longer term.

The global experience

The Integrated Reporting Framework was launched in December 2013 and since then has been used by companies across the world — mostly because they found a strong business case in being able to use it for improving the trust and confidence of investors and other stakeholders. The number of companies adopting this framework for reporting has witnessed a gradual increase. Though it owes its beginning to Europe, IR has found significant resonance in North America, Asia and Australia, with companies viewing it as a platform and framework that enables them to communicate much beyond what the traditional reporting frameworks provide for. Further, on 1 March 2010 the Johannesburg Stock Exchange (JSE) adopted the King III principles as part of its listing requirements, which mandate listed companies to apply

King III or explain which recommendations have not been applied and publicly provide reasons for that. King III recommends IR and hence the requirements for listed companies to issue integrated reports.

In India, the organizations that are considered pioneers in IR include Tata Steel, Wipro and Kirloskar Brothers. However, with the SEBI circular of February 2017, many Indian companies could consider working toward adhering to IR for the year upto March 2018.

SEBI could consider making this reporting process mandatory in the future, necessitating boards to consider the value that IR could deliver to the organizations, as also the steps that would need to be taken to prepare for addressing the requirements of this reporting standard.

Questions for the board to consider

1. **What is the effective view of the board about the benefits the organization can expect by adhering to IR?**
2. **What are the existing governance, risk management and control processes that need to be leveraged by the organization for IR purposes?**
3. **How aligned are all stakeholders of the organization on aspects that are crucial to delivering long-term value?**

Notes

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