2018 Governance Outlook

PROJECTIONS ON EMERGING BOARD MATTERS

A Publication of the National Association of Corporate Directors and Partners

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ABOUT THIS REPORT

2018 Governance Outlook: Projections on Emerging Board Matters is NACD's first publication of its kind, designed to give corporate directors and senior executives a comprehensive overview of major business and governance issues likely to demand board focus over the coming year. The report begins with an introduction from NACD, highlighting survey findings about leading board priorities for 2018, and follows with six partner contributions that provide distinct insights and projections on the following themes: business risks, board evolution, litigation, workforce disruption, and cybersecurity.

Each partner contribution provides (1) an overview of key trends in a particular area of governance, (2) an outlook for how those trends will play out in 2018, and (3) relevant implications and questions for boards to consider. *2018 Governance Outlook: Projections on Emerging Board Matters* is designed as a collection of observations to help corporate boards prioritize their focus in 2018 and increase their awareness of emerging issues, through both detailed topical analysis and coverage of broader governance implications.

The Future of Risk Management

By Bradley J. Preber

Corporate directors face serious challenges on multiple fronts. New technologies are creating new markets and disrupting business models. Tax reform could create windfalls or hamper international commerce. Weather events wreak havoc on regions and industries. Geopolitical volatility raises questions about whether to withdraw from, or invest in, global operations. Directors, therefore, see the current environment as highly risky—with good reason.

According to Grant Thornton research,[1] and our experiences in client engagements, corporate directors are most concerned about five risk areas going into 2018. Each of these areas warrant corporate directors' serious consideration as well as responses geared to the organization's exposure to these risks and opportunities to capitalize on them:

1. Overall risk management
2. Technology disruption
3. Growth and value creation
4. U.S. public policy uncertainty
5. Organizational culture

These areas present potentially greater risk exposure but, when they are proactively addressed, potentially greater opportunities. On that subject, owners and investors expect directors to exercise proper risk oversight and will hold them accountable for protecting and driving growth and value. Failure to respond to these expectations can result in ouster, social shaming, or hostile power plays.

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1. Overall Risk Management

Since passage of the Sarbanes-Oxley Act of 2002, many organizations have taken a procedural approach to risk management, settling for risk management processes that emphasize form over substance. Organizational risks are listed, charted, graphed, and circulated. Signatures are obtained, trainings are logged, and boxes are checked for the necessary purpose of documenting compliance with regulatory requirements.

Other organizations have adopted enterprise risk management programs that treat compliance as one part of the larger process of controlling and managing risk. Such programs have occasionally led to over-decentralization of risk management across divisions, functions, and process owners, thus diffusing ownership of risk and making it hard to develop a coherent view of enterprise risk. In such cases, directors must ascertain that the potential downsides of decentralization have been addressed.

The Impact of Technology on Risk Management

Future risk management processes will feature real-time integration and enterprise-wide sharing of internal data, as well as data from social media, crowd sourcing, newsfeeds, and other external sources. Employees will have ready access to information on existing and emerging risks and to ongoing analysis of exposures. Risk exposures in excess of tolerances will be automatically addressed using

[1] Grant Thornton LLP, *2016 Governance Risk and Compliance Survey*; Grant Thornton LLP, *2017 CFO Survey.*

artificial intelligence (AI) to redirect resources, mobilize stop-gap measures, or shift sharable risks to third parties. Imagine expanding into a new country and having the international risks measured and reported, work flows and monitoring assigned to process owners, additional controls triggered, and insurance coverage put in place, all through technology-enhanced mechanisms. Organizations that are preparing for that future now will be those best positioned to compete in it.

Within the area of overall risk management, directors and senior executives expressed concerns about operations and compliance risks and underscored several specific operations risks:

The estimated cost of Hurricane Harvey was $180 billion, according to Fortune.com.

Operations Risk

Operations risk encompasses all risks inherent in daily operations. These risks are typically managed through internal policies, processes, controls, and systems that reduce them to acceptable levels. In some industries, operations risk is subject to regulation.

Corporate directors and senior executives identified four top-of-mind operations risks:

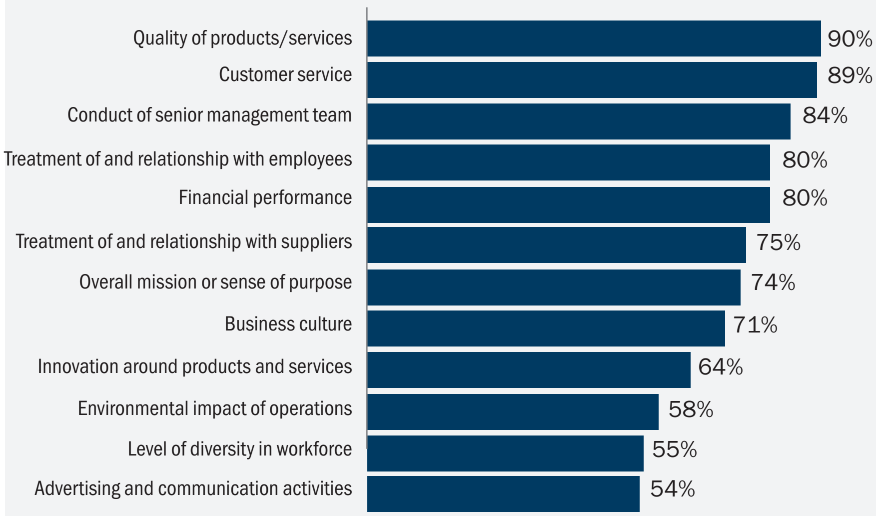
- **Cybersecurity Risk Becoming a Boardroom Staple:** Although cybersecurity has been a priority for years, concern has risen with widely reported breaches at a broad range of organizations. This risk will likely remain on board agendas permanently, with directors increasingly seeking clearer and more complete, relevant, and timely assurance regarding the organization's ability to identify, manage, and respond to cyber risks.
- **Business Interruption Concerns Are Accelerated by Recent Events:** Business interruption rose in importance due to damages inflicted by Hurricanes Harvey and Irma, the threat of war, skilled labor shortages, and political actions such as sanctions, embargos, and penalties for trade. These matters, along with changes in the underwriting of insurable risk, have many directors scrambling for ways to effectively oversee business interruption risks.
- **Accounting Changes Increase Risks for Fraud and Error:** With U.S. accounting changes soon taking effect, revenue recognition and lease accounting standards will become more susceptible to management judgment (and potentially fraud and error). These changes may also affect the way deals are modeled and challenge the expertise of financial specialists on the board. (See graph on page 11.)
- **Reputational Risk Is Rising:** Concerns continue over reputational risk and the resulting destruction or impairment of brand value. Lost customer trust can erode creditor confidence and shareholder value and draw bad press and social media coverage. As stewards of value, directors must understand this risk and management's methods of managing it.

Compliance Risk Persists

Failure to comply with internal policies and procedures or external laws, regulations, or standards creates compliance risk.

Yet wise management of this risk can create competitive advantage. In the future, organizations will achieve compliance while lowering costs and enhancing value through technology solutions and integrated risk management systems that shift compliance to process owners and even to customers. (Consider how often you are asked to enter your own data during a transaction.) Also, effective organizational cultures can lower compliance risks and costs further than purely policy-driven programs.

Factors Business Leaders Globally See as Most Critical to Reputation/ Brand Image



Source: Grant Thornton LLP, *Corporate Governance Report 2017*.

2. Technology Disruption

The changes wrought by technology disruption on markets, consumers, employees, and service delivery are everywhere. Boards must keep abreast of these changes and of the possibilities of AI, Internet of things, and robotics as they continue to pose risks and opportunities to the organization.

Creating a Blockchain Risk Management Strategy

This summer, David Longdon, a senior director for federal advocacy at CompTIA, who handles emerging technologies, discussed how the U.S. government is considering using blockchain to give citizens easy online access to services. This followed the formation of a congressional Blockchain Caucus focused on (1) digital identity guidelines; (2) enrollment and identity proofing; (3) authentication and life-cycle management; and (4) federation and assertions. If the U.S. government sees potential value in blockchain, directors should probably be asking, "How can our organization determine the applicability of blockchain to our business and the risks of adopting or ignoring it?"

3. Growth and Value Creation

Directors must oversee growth and value creation within the organization, yet tra-

WHAT IS BLOCKCHAIN?

"It's a public ledger in which transactions are made in some form of crypto currency and are recorded chronologically on a public ledger."

JOEL WATERFILED
Managing Director
Grant Thorton LLP (USA)

ditional business models, especially those depending on paid labor to drive value, are being undermined or upended. Therefore, directors are asking management to create innovative growth models that are less dependent on, or even independent of, existing modes of value creation. Emerging models include monetizing client-service intellectual property by charging for insights and ideas, using customer data to create and sell proprietary metrics, and entering joint ventures and alliances to match technologies with traditional sales delivery models.

Great Ideas: The Capital of the Future

This change generally requires organizations to identify and capture ideas, or intellectual capital, to be analyzed by experts for potential investment and commercialization. These efforts are breeding new consultancies and products to leverage creative approaches, such as crowd-sourcing, agile development, and "Shark Tank"-style knock-offs, to name a few.

Directors must determine what level of forward thinking is needed to fulfill their responsibility to protect and grow value. "How do we not become the next Encyclopedia Britannica or Blockbuster?" is the oft-asked question. Directors seeking answers will urge management to experiment with new forms of innovation, such as multiple small-scale pilot projects and rapid, iterative prototyping, to identify and develop new value streams and business models.

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4. U.S. Public Policy Uncertainty

In the United States, directors face turbulence created by an uncertain legislative agenda and regulatory environment. This uncertainty increases risks for directors, who must assess potential impacts on their organizations, and direct senior management, who must prepare useful responses. It also adds to the difficulty of making long-term investment decisions.

Predicting and Modeling "What-Ifs" to Shape Public Policy

In response, new approaches to risk identification, assessment, and response are being devised to better forecast impacts and outcomes. Directors are looking to accountants, economists, lawyers, lobbyists, and other external advisers to prepare predictive models, perform tabletop exercises, and develop action plans to address issues in play. Not content to be victims or spectators, they are proactively and urgently crafting plans to anticipate and influence policy matters.

5. Organizational Culture

Effective risk management calls for directors to help shape and to oversee an organizational culture that drives performance. Culture comprises the values, attitudes, and behaviors that an organization exhibits in its operations and relations with employees, customers, and other stakeholders. It is the glue that holds the organization together and a key determinate of risk and success. As such, culture warrants ongoing monitoring and attention.

Accounting Changes Increase Risks for Fraud and Error

Source: Grant Thornton LLP, *Corporate Governance Report 2017*.

Culture Is Being Managed as a Risk by Corporate Directors

Presently, most directors cannot adequately describe their organization's culture. Values remain undefined and not linked to desired behaviors or expected outcomes. Performance metrics omit values and behaviors and focus only on achieving targets, at times, in ways that contradict cultural expectations.

Many boards are working to build and maintain strong, cohesive corporate cultures. They are using internal controls to monitor behavior and ensure compliance with expectations and are evaluating vendors and customers for their cultural fit.

In Closing

Corporate directors understand which risks are creating adverse exposure and which opportunities should be seized. The five risk areas identified here stand at the top of most boards' agendas.

To address these risks, directors are urging management to integrate operations and compliance risk management and embrace technology. They are exploring new ways to create value through novel business models and proactive approaches to federal policies. They are shaping the organizational culture to generate the right results in the right way.

Boards that ignore these risks or adopt a wait-and-see attitude may well find existing business models shaken and face disruption significant enough to jeopardize the organization itself. In this context, directors might ponder the following questions as they evaluate today's risks:

- **Current State:** How effective is your organization at (1) identifying emerging risks, and (2) preparing for and managing those risks?
- **Alignment With Strategy:** Is your risk management integrated and aligned with strategy? If so, how are you assessing management's alignment of risk management with strategy?
- **Culture:** What is your organization's "risk management culture"? If it has been defined, how are you assessing its soundness and effectiveness?
- **Compliance Versus Risk Management:** Is your management team striking the right balance between compliance and risk management? Is it devoting enough resources to strategic risk management?

"It is surprising to see environmental and diversity issues so low on the list, when you consider how much discussion there is around those two issues at the moment—particularly in relation to businesses and corporate social responsibility."

SIMON LOWE
Chair, Grant Thornton Governance Institute
Grant Thornton UK

- **Cyber Risk:** Is your organization effectively integrating cyber-risk management into its overall risk framework? Is it exploring how to use cyber-risk management to strategic advantage?
- **Constant Change/Evolution of Risk:** Is your management team adopting practices to address evolving and emerging risks? Is it integrating risk management into real-time operations? Is your organization risk resilient?

Bradley J. Preber is the national managing partner for Business Risk Services (BRS). He also serves on Grant Thornton's Partnership Board. Mr. Preber specializes in complex claims and events, with a particular emphasis on commercial disputes and fraud claims. He frequently speaks, writes, and teaches on leadership, risk, accounting, and fraud-related matters. Wiley published his book *Financial Expert Witness Communication: A Practical Guide to Reporting and Testimony* and he co-authored *Data Analytics: Evaluating Internal Audit's Value* published in 2016 by the Institute of Internal Auditors Research Foundation.

National Association of Corporate Directors
1515 N. Courthouse Road, Suite 1200
Arlington VA 22201
571-367-3700
NACDonline.org