



## Taking the long-term view

2019 Directors' Alert

Global Center for Corporate Governance

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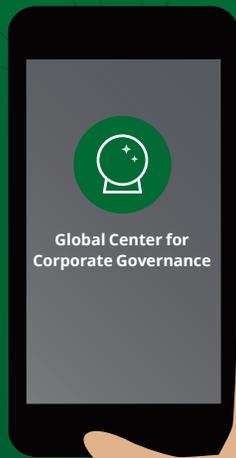
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# Introduction

Unflattering fluorescent lighting, yes. Tasteful, soft-cornered sconces, yes. There's even the occasional chandelier, dripping with leaded teardrop-shaped crystals. We've all seen lots of boardrooms, but never one with a crystal ball hanging from the ceiling. It's just as well, because it's rare to see boards look very far into the future, despite the mantras and slogans declaring a corporate passion for long-term success. This is odd, because directors are, above all, stewards of long-term value. They are uniquely positioned to consider the far-reaching impact of strategies and decisions, yet many boards and executive teams are tempted to focus on the short term. The pace of change, disruptive forces, and the demands of quarterly reporting all truncate time horizons in the boardroom with or without a crystal ball.

This state of affairs is concerning, because an organization's success depends on decisions and actions that occurred not yesterday, but well in the past. Today's advantages and challenges can be traced back to strategies, initiatives, resource allocations, hires, and relationships that were developed—or not developed—some time ago. By the same token, decisions made today will shape the organization of the future. The board has a duty to encourage management to plan for the longer term.

The 2019 edition of *Directors' Alert* identifies board responsibilities and focus areas that benefit from the application of a long-term lens. The fourth industrial revolution, often referred to as Industry 4.0, is driven by new technologies and relentless digitalization. It will require boards and management teams to plan for the long term and do so in new ways. The novelty and speed of Industry 4.0 may appear to demand snap judgments and rapid responses. That very urgency requires the board and management to grasp the long-term implications of this massive shift.

One question is how value will be created in a more digitalized world. Consider that governments and businesses have been working within tax frameworks established about 100 years ago, which are clearly not designed for a digitalized world. Unsurprisingly, the matter has caught the attention of tax authorities and should be found on board and management agendas, as well. There are implications for areas as diverse as strategies, business models, investments, talent management, corporate structure, and reporting, and changes we are seeing now

will affect organizations not only in the near term but well down the road.

Not all taxes are financial in nature, as the long-term costs of environmental, social, and governance (ESG) impacts become clearer. Strategies and decisions implemented years ago can result in ESG surprises that may have been avoided had a long-term view been taken. Those unexpected consequences can generate reputational, reporting, legal, financial, and other risks that the board needs to oversee. Societies, governments, consumers, workforces, and investors are becoming more attuned to and demanding of organizations' approaches to ESG issues. The board has a strong role to play and a duty to assist management in crafting actionable and sustainable responses and maintaining the operational discipline to see them through.

Investors' time horizons vary, but those who hold shares over long periods tend to be more vocal and visible to the organization and also deeply concerned with long-term value. There are, of course, investors with other priorities. Corporate leaders must understand and engage effectively with all shareholders and the larger investor community, particularly in an environment of intensifying shareholder activism and rising interest in corporate governance. This is an area that requires greater involvement of management and, in many cases, the board. It is certainly one in which the board, as the representative of the shareholders, must stay abreast of trends and developments.

As the ultimate stewards of the organization's long-term value, the board must look beyond the immediate future and guide management to do the same. The board should also urge management to take steps now to address conditions, risks, and opportunities that are likely to emerge in the years ahead. The more intense the executive team's focus is on the short term, the more important it is for the board to direct attention to the long-term impact of management's strategies, decisions, and initiatives.

Nothing less than the long-term value, and perhaps even survival, of the organization is at stake. 

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# Long-term value creation

## Understanding the fourth industrial revolution

The first industrial revolution dates to the 18<sup>th</sup> century, when the steam engine and other machinery radically changed the production and movement of goods. In the late 19<sup>th</sup> and early 20<sup>th</sup> centuries, electricity and assembly lines gave rise to mass production and the second industrial revolution. The third arguably began in the mid-20<sup>th</sup> century, when mainframe computers enabled the automation of processes and the creation of networks, including the Internet.

Views differ on the start of the fourth industrial revolution—Industry 4.0 for short—but all agree it is being driven by digital and cognitive technologies: advanced analytics, scanning and sensing, artificial intelligence, machine learning, the Internet of Things, and combinations of those technologies and physical processes and objects. The marriage of the digital and the physical is bringing us driverless vehicles, drone delivery, wearable technology, and robotic teams of homebuilders. These applications create exponentially greater value for far less effort, and they are already familiar in many industries.

Although business leaders need to distinguish between the hype and the real opportunities surrounding these technologies, it is as big a mistake to dismiss them as it is to mindlessly embrace them. This is particularly true as it applies to the board's role as steward of the organization's purpose and long-term shareholder value and its obligation to oversee risks. Industry 4.0 is certain to change organizations' long-term value, just as earlier industrial revolutions did. Organizations are presented with many opportunities to profit even as competitors seek to change not only the playing field, but the game itself. The risks that accompany these technologies differ from IT and other familiar risks. Both boards and management teams have work to do to ready their organizations for Industry 4.0.

### The transformative power of Industry 4.0

To grow and prosper in the Industry 4.0 environment, organizations must embrace digitalization and harness gains in computing power. Digitalization creates visibility into processes, allows real-time communication, and opens up new analytical capabilities. Tremendous computing power is now available to any organization through the cloud. For example, software as a service (SaaS) makes software deployment far more rapid and economical, while platform as a service (PaaS) simplifies complex processes. The economics of cloud computing enable Industry 4.0 for almost any organization.

The introduction of machine learning technologies typically requires a learning phase followed by a phase in which that learning is applied. The learning phase requires computing power at a scale most organizations cannot financially justify. That learning phase "trains" the system to recognize and make decisions on the basis of characteristics in documents, transactions, photos, videos, objects on a conveyor belt, or other content. It may require hundreds of thousands or millions of instances for the technology to learn what it must recognize and then do, and the cloud makes that kind of computing power available at a reasonable cost.

Once the machine has learned, costs decrease dramatically in the second phase, when it applies what it has learned to documents, transactions, objects, and so forth. The cloud, which can enable these technologies as SaaS or PaaS, democratizes cognitive technologies and is accelerating their adoption.

Cognitive technologies improve process performance exponentially, which is the usual motivation for adoption. First, the process of moving and inventorying materials, detecting product defects, monitoring predictive



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### How the C-suite sees Industry 4.0

To assess business and government readiness for Industry 4.0, a 2017 Deloitte global survey polled 1,600 C-level executives from 19 countries who represent companies with at least \$1 billion in annual sales.<sup>1</sup> The survey focused primarily on social impact, strategy, talent and workforce, and technology concerns.

Findings include the following:

- **Social impact:** 87 percent of the executives surveyed believe Industry 4.0 will lead to more social and economic equality and stability, with two out of three saying businesses will have much more influence than governments in shaping this future. However, less than a quarter believe their own organizations hold significant influence over societal factors like education, sustainability, and social mobility.
- **Strategy:** Only one-third of executives are highly confident they can act as stewards for their organizations during this time. Only 14 percent are highly confident that their organizations are ready to fully harness the changes associated with Industry 4.0. Most senior executives continue to focus on traditional operations as opposed to opportunities to create new value.
- **Talent and the workforce:** Only a quarter of executives are highly confident they have the right workforce with the right skills for the future. However, talent and HR are considered a relatively low priority (17 percent), despite 86 percent of executives saying they're doing all they can to create a better-prepared workforce.
- **Technology:** Executives say their technology investments are strongly oriented toward supporting new business models that will have an impact on their organizations over the next five years, but few say they have a strong business case for investing in advanced technology. The hindrances they most often cite are lack of internal alignment (43 percent), lack of collaboration with external partners (38 percent), and a focus on the short term (37 percent).

maintenance, or approving loan applications becomes more efficient. Then the process becomes more effective because the technology can do more. It can improve the quality of the materials being moved by monitoring and preventing breakage and rot. It can pinpoint product defects that were previously undetectable. It can monitor more parts of a machine for predictive maintenance and approve applications based on a broader set of documentation and external data.

Gains in efficiency and effectiveness have always been a goal in business, and although these improvements are part of Industry 4.0, they are not its essence. The essence of Industry 4.0 is transformation, not only of processes but of business models, organizations, entire industries, and work itself. Industries previously thought to be immune to disruption because they center on physical products and services, such as the retail, taxi, hotel, and travel industries, have been disrupted and transformed by digitalization. Others that were already digitized or content-driven, such as banking, trading, television, publishing, and advertising, have been totally transformed, primarily by the Internet.

Industry 4.0 should stand among the key pillars of any organization's strategy for the short- and long-term future. The options for executive teams and boards now come down to disrupt or be disrupted, transform or be transformed. For many, it's still a choice at this point, so now is the time to act.

### A board's-eye view of Industry 4.0

Many boards and executive teams are discussing Industry 4.0, but typically

apart from the main meeting agenda. This topic warrants a proper place on that agenda to incorporate it into the corporate strategy and investment choices for the organization, both in capability development and reinventing processes and ways of working. It's not enough for the board to be aware of uses of robotic process automation (RPA) or experiments in blockchain in the organization or at peer companies. The board needs to cultivate a clear understanding of the opportunities and risks Industry 4.0 poses.

A number of directors have found five broad practices useful for guiding conversations and framing actions related to Industry 4.0:

- **Preparing the board itself:** Some boards are more prepared than others to discuss Industry 4.0 with management. Digital technology organizations, such as Internet-based businesses or cloud service providers, generally have board members from the digital world who view cognitive technologies as not only an enabler of processes, but as a source of potential transformation. Other boards are populated by people with deep subject-matter and industry expertise but a more limited view of technology. Given that no organization in any industry is immune to disruption—and that many could derive benefits—the board must take explicit steps to prepare itself to understand the opportunities and risks that come with Industry 4.0. Across the globe, progressive boards are looking to enrich their work with technology-centric advice and thought leadership. Be it through CTOs, CIOs, cognitive/AI evangelists, or a strong connection with the

start-up community, these organizations are incorporating a significant voice in the boardroom on the adoption of Industry 4.0.

- **Readying the organization:** The board can also prompt management to consider the opportunities of Industry 4.0, starting with increased efficiency and effectiveness. Complacency and short-termism are the enemies here. Even an industry leader with a large market share, a high degree of customer loyalty, and updated technology could, in as little as a year or two, face a new competitor that is using cognitive computing to redefine core products or services or facilitate production and delivery. Perhaps more likely, a competitor could achieve economies that deliver similar results at deep cost savings, thus generating a stronger value proposition. Seeking gains and anticipating disruption can be especially difficult for leaders of highly successful organizations, where legacy thinking is often self-reinforcing.

- **Gaining access to needed talent:** Industry 4.0 will transform workforces at both macro and micro levels. Consider the implications of not just replacing but upskilling or reskilling a quarter, a third, or half of your workforce. The needed skills may be in short supply and not all of them can be acquired through technical training. Managers must become comfortable with experimental methods and with teams that could respond poorly to command-and-control supervision. Personnel will need to work in short, iterative sprints and be able to thrive in diverse ecosystems. Those ecosystems combine physical design, data science, scanning and sensing, cognitive computing, predictive modeling, and machine learning, as well as core functional and industrial knowledge. Success, even close to the front lines, will demand a roster of skills that no one person can master, requiring workers to adapt to highly diverse teams.

- **Elevating the risk conversation:** Management must address traditional risks involving cognitive technologies, and the board must gain assurance that those risks have been addressed. But other risks also abound, and they go beyond the usual playbook. There's the risk of being disrupted, choosing the wrong technology or timing, or missing transformative opportunities. Managing the risks of Industry 4.0 requires an understanding of the business, its processes, and how cognitive technologies behave. For example, as a machine "learns," it could acquire biases from the humans around it and start to discriminate against classes or ethnicities of people in a process designed to approve loans, triage customer service cases, or deal with suppliers. Change can lead to unanticipated consequences and risks. In addition to introducing new risks, Industry 4.0 elevates the level of risk, which means the risk conversation must also be elevated. Boards need to oversee risks related to Industry 4.0 and learn from management how those risks are being mitigated.

- **Choosing the right strategy:** Traditional long-term strategy is typically geared toward linear "big bang" projects, such as major IT installations, R&D efforts, and market initiatives with multiyear horizons and large budgets. These won't disappear, but they may become less critical to success, and a big-bang mindset may not serve the organization well in the long term. Worldwide, leadership teams are increasingly adopting strategic agility as their goal. This blends with an iterative, experimental approach to evolving the organization as the marketplace evolves. If you believe these technologies will impact your business, your long-term strategy should be to prepare leaders and ready the organization to adopt and scale these technologies. The best goal now may be to learn how adoption is likely to occur in your industry and business, how to respond to it, and how to identify

and address the opportunities and risks without a having a crystal ball to see how the business will look in five or 10 years.

These can be daunting and dangerous waters to navigate. One way the board can keep a firm hand on the tiller is by keeping management focused on the fundamental purpose and mission of the business. This is not to say that the purpose can never change. It may change along a continuum, as when an oil and gas company recognizes that alternate sources of power should be part of its long-term strategy. A new purpose may break with the continuum; for example, a bank may decide to move from taking deposits and making loans to becoming a payments-driven retailer, or a Silicon Valley tech company may decide to enter banking.

Boards and senior executives must keep their purpose and mission firmly in view and make explicit, periodic decisions to either maintain or alter them in response to Industry 4.0.

### What the board can do right now

To chart a course between unalloyed enthusiasm and unreasonable fear over Industry 4.0 and to help management do the same, your board might consider the following:

- **Get and stay up to speed.** Unless you have a genuine interest in their workings, do not worry about gaining a deep understanding of how machine learning, AI, RPA, blockchain, and other cognitive technologies operate. Instead, ask: What can and can't this technology do in an organizational setting? How does it treat or change inputs and outputs in a process? How do the people involved in the process experience it and its results? What sort of gains are achievable?

Separate hype from reality by learning where the technology is in terms of development, adoption, deployment, and

successful application. Having a direct line of sight and sponsorship from the board on a number of these incubations is common among organizations that are approaching this challenge head-on.

- **Start or change the conversation.**

Industry 4.0 and specific cognitive technologies should be found on the board agenda. Briefings from the technology owners within the organization should focus on how the technology will be used by the business and its related impact, rather than on the technology itself. External experts can help frame the possibilities. Draw management's attention to cognitive technologies' short- and long-term implications for the organization and ask questions to gauge management's interest and intentions. When management pursues gains in efficiency and effectiveness, raise the possibility of more transformative change. It's natural for management teams and boards to see cost reduction as the major benefit of cognitive technologies, but transformative change can provide even more value or, in the hands of competitors, pose threats to value.

- **Gauge the risks.** Understand both traditional risks and the new ones posed by Industry 4.0. Traditional operating, financial, and reputational risks may be amplified. For example, if a bot operating for a few hours can do the work of 10 people working for a week, that bot may have the potential to promulgate an error at a similarly exponential rate. New risks may be existential, such as threats to the organization's value proposition and business model. It is the responsibility of the board to ascertain whether these types of risks are being identified, assessed, monitored, and managed. Ask whether the organization has a formal program and platform for

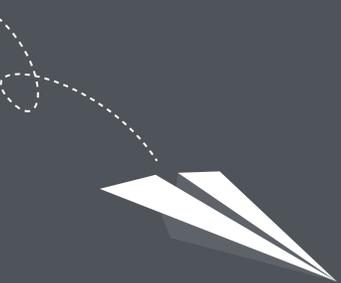
monitoring the external environment. Discourage management from dismissing new technologies and new competitors as immature, marginal, or unthreatening, because that is how almost all threats to established industries appear initially.

- **Encourage investment and experimentation.** Organizations should be investing to migrate repetitive processes that demand human intelligence to technologies such as RPA and machine learning. Depending on the industry sector, licensing or acquiring technologies could accelerate progress toward a target-state business or operating model. Moreover, cloud computing can make cognitive capabilities available at a fraction of the cost of internal development or outright acquisition. Ascertain whether high-cost, big-bang investments are necessary when a lower-cost, iterative approach may be possible. The audit committee may want to encourage internal audit to adopt RPA and advanced analytics in its assurance work and to foster the adoption of technology in second-line assurance functions such as operational risk management.

- **Monitor culture and talent issues.** Organizational culture is a deeply embedded, long-term characteristic that cannot be changed overnight. Board members should ask themselves: Does our culture position people to exploit the opportunities and address the threats posed by Industry 4.0? It is critical to work with management to frame the culture that the organization will need to maintain its reputation and ability to attract and retain talent in an Industry 4.0 environment. If the organization will need new types of talent, now is the time to develop the culture that will attract and support those professionals.

- **Continually clarify your purpose and mission.** Industry 4.0 will likely take the form of incremental improvements to processes, particularly when driven by cost and quality. When exponential changes occur, even positive ones, the fundamentals of an industry can change. Pioneering management consultant Peter Drucker famously noted that railroad executives believed they were in the railroad business rather than the transportation business and were thus blindsided by the airlines. How leaders define the organization's purpose will determine its approach to cognitive technologies. Gains in efficiency and effectiveness achieved by one industry participant are soon replicated by others, but organizations that undergo transformation find themselves altering the definition and experience of value. Clarifying an organization's purpose and mission can take a leadership team into deep philosophical waters, but they are waters the board should be willing to enter and help management navigate. Useful ideas and insights can also be gained by discussing the purpose and mission with key investors.

Although long-term strategy may seem an oxymoron in our current environment, decisions made in the year ahead regarding Industry 4.0 will affect the organization's value proposition, technological capabilities, workforce, culture, and operational agility going forward. Management should make thoughtful decisions on when to be an innovator or early adopter of cognitive technologies in light of company-specific circumstances, available resources, and stakeholders' needs and expectations.



## Questions for directors to ask

- What do we know—and not know—about Industry 4.0, both in general and as it applies to our industry and organization? What internal and external expertise can we access to learn more?
- Which cognitive technologies have we deployed in the organization? Where have we deployed them? What have been the results? Are we seeing incremental or exponential gains in efficiency and effectiveness?
- How prepared is our organization to begin or move to the next stage with cognitive technologies? What assumptions underlie the decisions management has made (or not made) about these technologies? Have we assessed the adaptability and maturity of our organization in navigating this complex transition?
- What risks do cognitive technologies and Industry 4.0 pose to the organization? What are the operational, financial, cyber, reputational, and other known risks? What are the larger risks to our value proposition, business model, and strategy?
- What developments have Industry 4.0 prompted among our competitors and peers? How are new market entrants or organizations on the periphery of our industry using them? How are our customers and suppliers using them?
- How should our organization pace itself on this journey? Where do we want to be innovators or early adopters? Would a strategy of later adoption better serve our organization and its stakeholders?
- How is the board planning, testing, and refining its journey to Industry 4.0? How are we measuring and enhancing the board's collective capability to understand the organization's range of options related to Industry 4.0?
- How can the board best support management in preparing the organization's workforce for Industry 4.0? What people and skills will be needed? What changes will the organization need to make in its hiring, training, retention, and workplace policies to win the war for talent?



# A conversation with Elizabeth Corley

Elizabeth Corley serves on three company boards as a non-executive director: Pearson plc, BAE Systems plc, and Morgan Stanley Inc.

Elizabeth was CEO of Allianz Global Investors, initially for Europe then globally, from 2005 to 2016 and continues to act as a senior advisor to the firm. She was previously at Merrill Lynch Investment Managers and Coopers & Lybrand.

She is a member of the CFA Future of Finance Council Advisory Council and the AQR Institute of Asset Management at the London Business School. She is chair of an industry Taskforce for the UK government on social impact investing.

Additionally, she is a member of the 300 Club and the Committee of 200, as well as being a trustee of the British Museum. She is also a published author and a Fellow of the Royal Society of Arts.

## How can boards plan for the long term?

Most boards realize that successful strategy stems from their ability to think long term while acting on the basis of that thinking in the shorter term. Boards need to work with management to shift their thinking from planning at the present and beyond to starting instead with a vision of a longer-term future and then defining near-term actions that will make that future a reality.

Thinking long term can be difficult in an environment where analysts fixate on quarterly reporting. The availability and velocity of data, along with shrinking attention spans, reinforce short-term expectations. However, boards know they must balance short-term performance against longer-term considerations, and that investors expect leaders to deliver current value while innovating for the future. All of this means that anything done slow, late, or wrong in short-term execution has a much higher opportunity cost than it would five or 10 years ago. That's because driving current efficiencies creates the space needed to shape long-term value.

## Are boards thinking about Industry 4.0?

Boards are thinking about Industry 4.0 on multiple levels. One level is defense of the business model, of operating systems, data, and of sustaining a social license to operate. Another level is being on the offensive—using insights, innovation, and technology to reshape the organization and the market. Boards should be updated regularly on cyber risks and cyber issues, but many are not receiving useful insights,

which should go beyond normal “IT risks.” Another level of focus is talent, an area where some organizations have been slow to appreciate the strategic relevance. You need the right people to exploit opportunities of Industry 4.0, and they're probably not always the people who assumed senior positions in the past decade. Many companies get Industry 4.0 in theory but have not developed the mindsets and mechanisms to act on its implementation.

## How can boards ensure management has the right leaders during these times of change?

Boards are thinking harder about what's needed in leadership: performance or potential? I've seen a shift in mindset from sourcing people who were very results-oriented to those also focused on the future. This goes back to balancing short term and long term, and it involves culture. A purely short-term-oriented culture will work against a company unless, of course, it is facing pressing operating or financial problems that must be immediately addressed. Companies that are doing well can and should develop long-term thinking as part of their cultures. They can seek or develop talent for the future, instill continuous learning, and develop resilience. Industry 4.0 reduces the amount of control organizations have and leadership will have to make the necessary adjustments. Those that understand this are engaging with stakeholders in new ways and adapting to change quickly. Those struggling with this change are usually trying to maintain their former control.

**Are boards engaging with investors to understand their views for long-term success?**

It depends on where the company is in its relationship with investors, but yes, boards generally appear to be increasing their engagement with investors. I am seeing both passive and active investors asking for engagement outside of the quarterly or half-yearly reporting cycle. A board I sit on hosted a "governance day" where the chairman, CEO, and committee chairs invited investors to talk about governance, and it was very well attended. There was no talk of earnings or performance. The meeting focused only on governance, culture, and how the company is run. I am also seeing more sophisticated questioning from investors and proxy voting agencies about boards and their competencies and dynamics. Investors will ask a chair about governance and oversight, particularly in fast-evolving industries.

In periods of rapid change, investors face more uncertainty in securities pricing and the role of specific securities in their portfolios. That increases the need for management to present a clear and cogent narrative, often across a diverse investor base. Doing that is now a hallmark of successful investor engagement. Another one is having a good understanding of the investor base and sharing that understanding with the board. The boards I sit on receive current, relevant information on the buy-side and sell-side views of the organization.

**What ESG topics are being added to the board's agenda?**

Governance has certainly risen on the agenda. In the United Kingdom, it's been driven by revisions to the Corporate Governance Code, and in the European Union by increasing expectations regarding board accountability. I recently saw a presentation on factors correlated with long-term share price volatility and performance in the United States, Europe, and Japan. Governance was the only factor associated with lower volatility and/or higher performance across all geographies. The presentation suggested that the better the quality of the governance, the lower the volatility and the better the share price performance over the long term.

**Which governance concerns are under the most scrutiny?**

Key things stakeholders look for include a well-articulated strategy; governance processes; high-caliber people; solid succession plans; appropriate, diverse board composition and committee structures; and independent thinking and judgment from non-executive directors. Beyond those themes, things can become more specific depending on geography. For example, there is now guidance in the United Kingdom that if you are going to chair an important committee you should have been on the board for at least a year.



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### **What about the environmental and social components of ESG?**

The environmental component is becoming more central, partly because of policy developments, but also because sustainability impacts the supply chain. In addition, investors are focused on identifying external factors that may not be reflected in current share prices and/or business performance. Many leaders are rethinking the impact of climate change, weather-related events, and natural disasters on just-in-time (JIT) globalized supply chains, as well as the impact of political actions such as Brexit. Management and boards have gone from being able to rely on a relatively benign, continually globalizing world with predictable outcomes to realizing that JIT may not embody the resilient supply chain of the future. That's a big shift.

In the social area, leaders are thinking about employment and purchasing practices, inclusion and diversity, and long-term value creation for customers. They are also acutely aware of the ability of consumers to gather information from social media and for organizations to be targeted for attention or action. As a result, organizations are assessing their approaches to culture, risk management, and controls in their supply chains. Years ago, it was assumed that many issues would be outsourced. So, particularly at large organizations with significant brand equity, leaders realize they cannot assume they outsource responsibility when they outsource an activity.

### **Has the board's oversight of tax changed, and is it being considered a long-term matter?**

Yes, both at the full board and audit committee level. Where tax optimization used to be the highest priority, now there's a balancing focus on tax equality. In the United Kingdom and Europe, there's an expectation to report on the fairness of the tax strategy, not only on optimization. Shareholders are sensitive to an organization's reputational risk associated with underpayment of tax. Executives and boards are engaged in a more balanced discussion about paying taxes fairly. This is driven partly by consumer reactions to organizations using sophisticated, but perfectly legal, tax optimization structures but also by government intervention.

A couple of years ago, one of the boards I sit on decided to produce a separate report on tax. This helped us to have a transparent conversation with any stakeholders interested in the subject. It doesn't only explain the effective tax rate; it also shows where we pay taxes and what we pay. In Europe, I've also seen reports on the amount of payments associated with wider stakeholders, such as employees and specific communities, and on local tax, national tax, and so on. There is clearly a much more thoughtful approach to tax management.

### **What else should be boards be focused on for the long term?**

Each of these issues can impact reputation. You'll find brand, reputation, and customer experience in highly sensitive parts of the company's risk register. When that's the case, management must mitigate those risks. The board and/or the risk committee should be having conversations related to these matters with management and monitoring related views across constituencies. Some boards have established ESG committees, or responsibility and reputation committees, brand committees, or stakeholder committees, to monitor these issues. Of course, some companies have decided that it's not one of their priorities, but they are living with a higher appetite for reputational risk.





# Investor engagement and activist shareholder strategies

## What the board needs to know and do for the long term

It's not your imagination: shareholders and activists have asserted themselves more in recent years. For better or worse, activists are more numerous and more diverse than they were in the past, both in their agendas and their methods. This reinforces the need for management, with the board's oversight and guidance, to engage with shareholders proactively, to be prepared for friendly or confrontational activists, and to have a long-term plan for shareholder engagement. It's also essential for the board to consciously craft its role in this tricky area, where it is expected to both represent shareholders and advise management.

Shareholder activism has always existed, but its goals and tactics have changed over time. In the 1980s, corporate control was the chief goal, and takeovers, poison pills, and greenmail were common tactics. Corporate raiders wanted to acquire businesses or take controlling positions with the aim of reshaping or dismantling those businesses. Today's shareholder activism is different. The goals are more often to unleash or create value without a change in control, and to do so by leveraging a small ownership percentage—generally three to five percent. Some investors have exerted significant influence, usually in conjunction with other investors and often by stating their view of a company's prospects and making recommendations without undue publicity. Others have chosen to be more confrontational and public in their demands.

Regulatory and technological changes also have disrupted the traditional balance of power between management and shareholders. Regulatory measures, such as the Dodd-Frank Act in the United States, have heightened public awareness of corporate governance and, more

specifically, the board's oversight role. Dodd-Frank instituted a say-on-pay shareholder vote, and although it is not binding on companies, it has emboldened investors and amplified their voice. This is particularly true when it comes to executive compensation, which investors often view as an indicator of potential governance weaknesses elsewhere in the organization. Digital technologies have transferred a measure of organizations' control of information to investors. Today, investors and other stakeholders can communicate with millions of people at the click of a mouse rather than waiting for reports to be delivered by mail or other pre-digital methods.

Diminishing trust in institutions and publicly held corporations, the abundance of cheap debt, and the market environment following the Great Recession have also prompted shareholders to exert more influence on management and the board. Activist investment funds have proliferated, both feeding and feeding off these trends and raising significant capital that they must invest in ways that generate returns. They typically wrangle with organizations over issues such as capital structure, shareholder value, management competence, board composition, asset sales, and major business issues or decisions.

These recent trends suggest that management should proactively engage with investors and be prepared for activists with strong points of view. The board needs to oversee and advise management regarding these efforts and the risks and opportunities that investor engagement and shareholder activism present in the short and long term. In some recent cases of investor engagement and activism, the board can become directly involved. In fact, in recent years, some



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### No company is immune

A Deloitte survey<sup>2</sup> of CFOs of US public companies conducted in 2015 identified the following trends. Our experience indicates these trends still hold true, and in some cases, they have intensified.

- Just under three-quarters of US public companies surveyed experienced shareholder activism, most often in the form of direct communication to management or the board.
- About 30 percent experienced indirect communication in the press or social media.
- About half made at least one major business change because of shareholder activism; the most common were share repurchases, management or board changes, divestitures, and performance improvement initiatives.

Because shareholder activism shows no sign of abating, companies may need to review their approach to investor engagement and arrive at response protocol to implement when an activist emerges on the scene.

board members together with management have proactively sought out investors—and have opened up a direct line of engagement. Initiatives like these highlight just how prevalent this issue is becoming for boards of directors.

### Understanding today's activism

Trends in shareholder activism tend to begin in the United States and then extend elsewhere. There are structural reasons why activism is relatively less common in Europe; for example, majority control by families and other organizations makes it more difficult. In Asia, state-owned, listed companies are resistant to activism. Culture also influences where activism takes root. Some highly regulated sectors such as financial services, media, defense manufacturers, and utilities tend to have some natural insulation against shareholder actions, but that does not render them immune. Virtually any public company can be subject to shareholder activism.

Activism most often comes down to differing views on how capital should be allocated. There is an ongoing discussion in the marketplace about the short- versus long-term orientations of activists, but the fact is that different activists simply hold different views.

Many institutional investors, particularly pension funds and insurance companies that seek to match assets with liabilities over the long term, want to invest in companies with well-established strategies and an established record of performance. Senior leaders of some prominent investment funds also have expressed a strong desire for their portfolio companies to take a long-term view, but not all investors in a company will share those goals and interests. Different investor classes will have different investment goals, time horizons, and priorities, which can create conflicting objectives and opinions among shareholders and complexity for the organization's senior leaders.

A given company's activists and broader shareholders are not homogeneous. When the current wave of activism began, many corporate leaders and observers characterized all activists as seeking short-term monetary gains in ostentatious ways. In truth, many have been discreet, constructive, and respectful in making their cases to companies. They often have longer-term concerns and limit their efforts to conversations with management and suggestions for boosting performance or eliminating underperforming assets. Others have been quite aggressive, leveraging the media to dramatic effect with the goal of altering the structure of the board, replacing senior executives, divesting specific subsidiaries, changing ESG policies, or transforming operations.

The companies most attractive to activists tend to be those with strong cash flows, low dividend payout ratios, conservative balance sheets, recent underperformance, or assets ripe for selling or spinning off. Other targets are those companies operating in industries marked by shifting market forces and changing business models. The board should be acutely aware of all these conditions and actively discussing them with management regardless of activist activity. Activism merely sharpens the focus on such issues, and it might intensify the need to address them.

Efforts to address shareholder activism are most productive when they are viewed and conducted in the context of a robust investor engagement program, usually found within the company's investor relations department. Strong investor engagement enables management to understand the company's shareholder constituencies and their goals, monitor changes in the makeup of the shareholder base, communicate short- and long-term strategies effectively, and cultivate both reliable supporters and trusted critics in that base.

As part of its oversight and governance responsibilities, the board should ensure that management has established an investor engagement program and has taken steps to prepare a response to either friendly or confrontational activists when needed. The board must also coordinate its thinking and approach to activism with management and the investor relations team. It is critical to create and enhance a robust capital allocation methodology that is communicated externally in an appropriate manner.

### Establishing the board's role

There is some diversity of opinion regarding the board's role vis-à-vis interactions with shareholders, weighted toward the board leaving management responsible for engaging with shareholders. However, some maintain that the board has a responsibility to engage with shareholders as their representative. In practice, we are seeing more board engagement today than in the past, but senior executives and the board need to establish clear guidelines regarding how and when the board engages with shareholders.

A company's investor relations group is the main channel for communicating with shareholders, and that function reports to management, and often to the CFO. Encouraging shareholders to approach the chair or board members directly could call into question the value of the investor relations function, and perhaps of the management team. If shareholders bring a concern to the board's attention, it may be appropriate, in some cases, for the board to engage with those shareholders in concert with the investor relations group. Having the chair engage with shareholders is a common practice in a limited number of countries, including the United Kingdom, Australia, and South Africa. However, direct chair or board engagement with shareholders in the normal course of business could risk blurring the lines between

overseeing management and actually managing the organization, especially if there are no protocols in place for the board's involvement.

A company's investor relations function exists to inform, to answer questions, and to explain the organization's strategy, markets, and performance to shareholders and the investment community. This should not be a perfunctory exercise in information distribution, but a means of deploying an ongoing narrative and for meeting shareholders' and investors' genuine need for information. It should also seek to create a feedback loop with shareholders and the market. Investor relations involves sending messages to the marketplace, but also gauging how investors are receiving those messages. Do investors see the information as transparent and complete enough? Do they understand management's short-term and long-term strategies and risks to those strategies? Are they confident in the leadership team? Do they hold misperceptions about the company or stock? A successful investor relations function monitors the marketplace and shareholder sentiment to obtain the answers to these questions.

In the survey cited previously, we asked how companies are changing their approach to investor relations in response to activism. About half said they had changed very little, with most citing existing programs that were working well. The half that had made substantial changes most often cited increased monitoring of activist activity, enhanced planning in response to activists' concerns, and more proactive communication with investors.<sup>3</sup>

The board should be aware of the shareholder base and its needs; the investment community's perception of the organization, including its management team and performance; and the organization's vulnerability to activist

shareholders. Management should update the board regularly on the composition of the shareholder base and how satisfied they are with the information they're receiving on the company's capital structure, performance, and other factors that could drive questions and activism.

Additionally, the board should be open to not only listening to shareholders, but also to collecting input from them, for example by attending investor conferences to observe the proceedings and hear what's on investors' minds. These efforts could also extend to more direct interaction with specific investors. But, despite a recent increase in board members engaging with investors directly, board-shareholder interactions are generally limited as long as the company is performing well and there are no concerns or crises. The primary points of contact for investors should generally be investor relations personnel and management.

If a decision is made to have a board member engage with a shareholder, he or she should be an independent director. After all, if a shareholder approaches the board, it will often be due to dissatisfaction with the organization's performance or its handling of an issue. To add objectivity to the discussion and insulate management, this discussion should be with an independent director rather than an executive director.

Effective investor engagement provides visibility into the strategy, operations, performance, and finances of the company, as well as realistic expectations. It's a matter of describing an investment opportunity in ways that enable investors to decide with confidence whether it meets their objectives. A company cannot be all things to all investors. By providing the clearest possible portrayal of the organization and working to deliver optimal long-term value to shareholders, management and the board

position themselves for favorable interactions with investors.

That said, some investors will have activist agendas from the outset, and others may develop activist tendencies if it's in their interest and, usually, in the interest of the company. The board has a duty to see that the company is prepared for activists and responds to them effectively.

#### **Actions to consider in light of activism**

Shareholder activism should encourage boards to step up their investor engagement oversight efforts, recognizing that different boards and different directors will take different approaches. For example, some obtain updates from their investor relations teams at every board meeting, while others do so once a year. In some cases, directors even meet directly with investors. Yet very few omit shareholder engagement from the board agenda, and those that do act at their peril.

When authorizing corporate actions, the board should consider the views and priorities of key shareholders and shareholder segments. For example, if the company is going to undertake a share repurchase program in lieu of reinvesting that capital in the company, the board should consider the potential effects of that decision on shareholders. Decisions that involve either raising or allocating capital always warrant close scrutiny and an understanding of shareholders' views and expectations.

In that context, the board should also:

- **Exercise strong risk oversight and organizational governance.** The boards of most public companies have gone well beyond simply approving management decisions. They seek to truly understand and provide advice on strategies, business models, and major investments and initiatives. True understanding requires sound governance of the processes by which decisions are made and initiatives are undertaken. Sound governance involves

gauging the long-term impact of management decisions on the organization's performance and value and the effects on investors, employees, and environments in which the organization operates. The board needs clear lines of sight into decision-making processes, reliable assurance regarding the risks implicit in management's assumptions and decisions, and the willingness and ability to challenge management when needed.

- **Monitor the company's shareholders and their goals.** Through surveys, discussions with management, and external perspectives, the board should monitor the makeup of the shareholder base and understand the reasons for its composition. For example, industry factors may influence the diversity of shareholder institutions and objectives. Although it is outside the board's control, the makeup of the shareholder base will reflect investors' views of the organization and management's strategy and performance, and the board must be aware of those views. The board should also be cognizant of issues such as a misalignment between compensation and performance, large and long-standing cash holdings, and activists targeting peer organizations.
- **Ensure that the company's investor relations team performs well.** The investor relations function should articulate a fact-based investment proposition that makes a clear case for why management's strategy and decisions are better than alternatives. The function should stay in front of developments that could prompt activist activity, such as industry reversals, poor performance, or negative media coverage. It should also respond quickly to shareholder demands for information and cultivate good relationships with major shareholders, who can be invaluable in mounting an activist defense. An adequate staff of well-qualified people should work closely with the CEO and the CFO to communicate a compelling value proposition

and strategy. Boards also need to receive periodic reports from the investor relations group; some receive them at every meeting and others only annually. Regular updates are imperative.

- **Request an activist vulnerability assessment.**

Companies should periodically commission an activist vulnerability assessment, which takes an objective, outside-in look at the company. It is difficult for management or the board to be objective in this sense, given that they formulate and approve the strategy and are responsible for performance. These assessments consider factors such as market capitalization relative to the sum of the company's parts, financial performance versus that of peers, and the stock's trading range relative to that of similar companies. It identifies underperforming lines of business as well as nonoperating assets, such as real estate, that could be monetized. The composition, skills, tenure, and performance of the board is also considered. This kind of assessment not only helps the company prepare for an activist event, but also identifies opportunities to lower the organization's vulnerability to such an event.

- **Review management's activist-campaign response plan.** As with any event that has the potential to influence a company's reputation, management should be prepared to respond to an activist campaign. The plan should include protocols for responding to friendly activists and those taking a confrontational approach. The plan should identify the members of the response team and their responsibilities and provide guidelines on who should be informed (including the board), when they should be informed, and who formulates and delivers which types of responses. The first rule of activist response is to never ignore or stonewall, either of which can elicit frustration and aggressiveness. Management needs to prepare an internal communications program

to keep employees informed and focused in situations where activists go public. Failing to communicate internally will only foster rumors and distraction. Consider including financial, legal, public relations, and accounting advisers in the response team. Also designate specific members of the board, such as the chair of the compensation, governance, and other relevant committees to be involved in specific issues and communications. Shareholder communications should be structured to make higher levels of executives available if an issue escalates.

Ongoing monitoring, proactive engagement, and deep preparedness will generally head off most serious problems and enable a swift and effective response to those that do arise.

### **Engage and embrace**

Shareholder activism has advantages as well as drawbacks. On the down side, confrontational activists can launch highly public campaigns that can distract management and cost millions. They can also disrupt customer and supplier relations, create openings for competitors, generate uncertainty, and discourage potential employees. On a more optimistic note, many companies have benefited from activists who have directed management's attention to opportunities to accelerate growth, improve the bottom line, monetize assets, or return capital to investors. The management team and the board must be prepared for either constructive or aggressive activism both in the immediate future and for the long term.



**Jonathan Goodman**  
Global Managing Partner,  
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## How strategy can halt the excesses of activism

No industry or public company is immune to shareholder activism. Some activists are constructive, others confrontational.

Activist shareholders often wish to exploit a company's real or perceived vulnerabilities. Their scrutiny can include a company's performance and prospects, portfolio composition, capital allocation, and governance. In fact, activism, when combined with today's dynamic, disruption-filled environment, can bring about greater scrutiny than ever before.

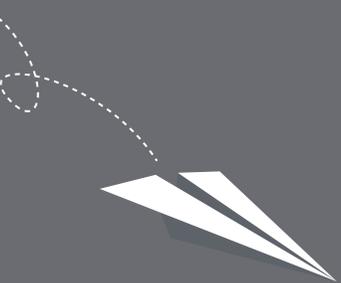
While some shareholder activists are unconstructive, there are cases where senior executives and boards should view shareholder activism not just as a challenge to overcome, but as an opportunity for growth and value creation. That opportunity is best met with what has always been the bulwark of a company's survival and future: a clear strategy.

No matter how large and complex or small and focused a company is, every company has a strategy. But simply having a strategy is not enough to defend against activism. Rather it's management's ability to convincingly articulate and execute a coherent and compelling strategy that helps manage activist challenges successfully.

The company's strategy should address where and how it intends to win and create value over the long term given its aspirations and the realities of how markets, customers, competitors, and advantages are changing. A good strategy reflects genuine choices and a continually improving value equation for the company's customers.

In this context, the board of directors has important responsibilities relating to activism and strategy. Some of these include:

- **Ensuring that management has a winning strategy.** Under every circumstance, the board should confirm that management has a winning, executable strategy in place and at work today. This is not a call for the board to take responsibility for strategy, but for the board to apply tough standards when weighing, vetting, and ultimately endorsing management's strategy.
  - **Viewing a company's strategy through an activist lens.** Periodically, the board should instigate a stress test of the company's positions, prospects, and strategy through the lens of an activist investor. The intent is to challenge the direction of the company and the assumptions that underpin that direction. Do the assumptions hold up in the face of reality? Are there choices or moves that an independent and dispassionate actor might suggest that merit consideration? What would an informed and aggressive activist investor say about the company?
  - **Encouraging engagement rooted in strategy.** If faced with activist pressure, the board should encourage constructive and proportionate engagement. Such engagement is likely to be more compelling if it is coupled with a well-told and well-executed strategy.
  - **Leveraging real or potential threats of activism.** Ultimately, the board should consider activist pressure as a potential opportunity. By listening and reflecting on signals from the marketplace, savvy boards can take advantage of possibilities for value creation and defend against the excesses of short-termism.
- Far from being a supporting player in activist confrontations, strategy should occupy a central role for those management teams and boards hoping to see the benefits that can result from productive activism.



## Questions for directors to ask

- What is our approach to investor relations? Do we have a shareholder engagement plan? How proactive or reactive is our company when it comes to shareholder engagement?
  - Who is involved in our shareholder engagement program and who is responsible for which activities? What are their qualifications, competencies, and capabilities? How are we measuring the program's performance and success? How is the board involved?
  - What is the detailed composition of our shareholder base? What are the motivations and goals of various segments of our shareholder base? How do we know?
  - How, and how often, do we assess the perception investors have of us, our management team, and our company?
- Are we aligned with the expectations of our primary shareholders? How do we reconcile expectations among our various shareholder segments?
- How comfortable are we, as a board, with our understanding of management's strategic and investment decisions? How do we maintain sufficient visibility into the processes by which those decisions are made? How well are we governing the process by which management formulates strategy and makes decisions?
  - How prepared is our leadership team for shareholder activism? What has been our experience? What have we done right? What could we have done better? How can we improve our current level of preparedness?



# A conversation with Melody Hobson

Melody Hobson is the president of Ariel Investments, and serves as chair of the Board of Trustees of Ariel Investment Trust.

Melody also serves as vice chair of the board of Starbucks Corporation, and as a director of JPMorgan Chase. She is the former board chair of DreamWorks Animation. Furthermore, she is a board member of the Rockefeller Foundation, George Lucas Education Foundation, and Lucas Museum of Narrative Art.

As a Chicago-native, Melody is involved in numerous organizations that focus on improving the city. She serves as chair of After School Matters, and as a board member of The Chicago Public Education Fund. In 2017, Melody became the first African-American woman to become chair of the Economic Club of Chicago in its 90-year history. She is a regular contributor for CBS News, provides weekly money tips on the *Tom Joyner Morning Show*, and authors a column for *Black Enterprise Magazine*. In 2015, *Time Magazine* named Melody as one of the 100 Most Influential People in the World.

## **How do boards distinguish between long-term and short-term thinking?**

It's hard to generalize. At Ariel—we call ourselves “the patient investors” and have a turtle as our logo. We believe that the long term is the foundation of how we think about investing in public companies. To me, the long term is about strategy and driving long-term shareholder value and growth, while the short term is more about tactics. Your long-term strategy and growth help determine your short-term tactics, and your short-term tactics support your long-term strategy and growth.

## **How are directors applying a long-term lens in the boardroom?**

As investors, we are not about investing for the next quarter or even the next year's earnings. We consider the underlying value of businesses over time, and I bring that perspective with me into boardrooms. I believe many board members share that view of long-term value creation. The challenge is dealing with the day-to-day real world of Wall Street, the media, and various constituents. While a board has to consider constituents' issues and concerns, I believe the job of a board member is to drive long-term shareholder value.

## **How can boards avoid being overly short-term focused?**

A good board avoids getting caught up in the day-to-day noise, because that's what most of it is. A good board stays focused on a clear goal that is supported by a strategy and a plan. A plan that can be

adjusted. Warren Buffett once said that champions adapt, and you have to adapt, often due to short-term issues. You have to walk some fine lines.

## **How do you, as a board member, walk those lines?**

I often ask myself, “If we were a privately held company, what would we do?” It's a way of setting aside forces that might lead you away from the best decision if those influences were not present, which they wouldn't be if you were a private company. If there's a difference between the decision you would make as a private company versus a public company, ask yourself why that is. You can isolate forces that might lead you down a short-term rather than long-term path. That question helps me anchor my thinking.

## **How are boards thinking about technology-driven disruption?**

That's a big topic that dominates a lot of boardroom conversations, and it's an important one. If a board is not having that conversation, it would be problematic. Everyone is trying to see into the future to understand what will help and hurt the company in terms of technology, and this goes across industries. We see those conversations across all organizations from small and mid-cap domestic companies to global organizations.

**Are boards recruiting more directors with tech and IT experience to their ranks?**

Board members with digital expertise are in high demand. When people tell us they are looking for board members, they often want people with digital backgrounds. A few years ago, it was more about financial expertise, especially 10 to 15 years ago, after Sarbanes-Oxley and the financial crisis. These director qualifications often come in waves, but currently the demand for digital expertise is strong.

**How can boards be proactive in anticipating these changes?**

Good boards try to see around corners. That's part of their job. That doesn't mean they can be sure of the answer, but they try to anticipate. Good boards are proactive.

**Should board members speak directly with investors?**

I think it's a bad idea to have board members talking one-off with investors. Investor relations should serve as a strong voice for the company, and obviously the executive team deals directly with investors. There are situations where an investor might ask to meet with a lead director or chair if the chair and CEO are separate. I had that experience when I was chair of DreamWorks. But that does not occur on the fly—it is typically done with thought and intention.

So, I have not been in a situation in which random investors call to speak with me, nor would I make myself available in that way. There are times, at Ariel, where we will ask to have access to a chair, but we do that through the company in which we've invested. I think a company should always have a very unified and thoughtful message for investors.

**What can a board do to understand the makeup of the shareholder base in terms of their short- versus long-term orientation?**

That depends on the company, and different boards do it differently. You'll typically have investor relations reports that portray your top investors, the conversations the company is having with them, and the key issues they're raising. Because I am in the investment business, I have a good sense of the firms that are out there and their reputation, and I see the difference between growth-oriented and value-oriented investors. So, I probably have a different lens when viewing top investors than most directors. In a well-run company with an engaged board, you have a very good sense of the shareholder base and their concerns.

I also read the Wall Street research on our companies, those we invest in, and those where I am on the board. That allows me to see on a regular basis what analysts are saying about our companies, and we review that information in the boardroom.

Good boards think long term about every issue and decision they face.



**How do boards respond to analysts' reports, whether positive or negative?**

I actually don't react. I am focused on the long term and on strategy. Sometimes the points being articulated can be noise or do not reflect the current situation. When I read those reports I tend to look at the themes or at areas where we are not communicating as well as we should. I also get a sense of our competitors from reports that compare companies. It is simply information I want to know, and I want to understand what is being said. I think the idea of reacting to it would be missing the point, because I am focused on the long term.

**What major ESG areas should boards be focusing on?**

Ariel has expertise in ESG and we've been involved in ESG-related issues for much of our history. I think the evolving themes are obviously around climate and climate impact, as well as governance. We're also seeing institutional investors increasingly concerned about governance-related issues like gender and ethnic diversity on the board, as well as the environmental impact of business.

However, measurement and standardization are very challenging issues. There's a real lack of standards, which leads to a great deal of interpretation and many differences that make this area challenging for investors.

**Are organizations rising to this challenge?**

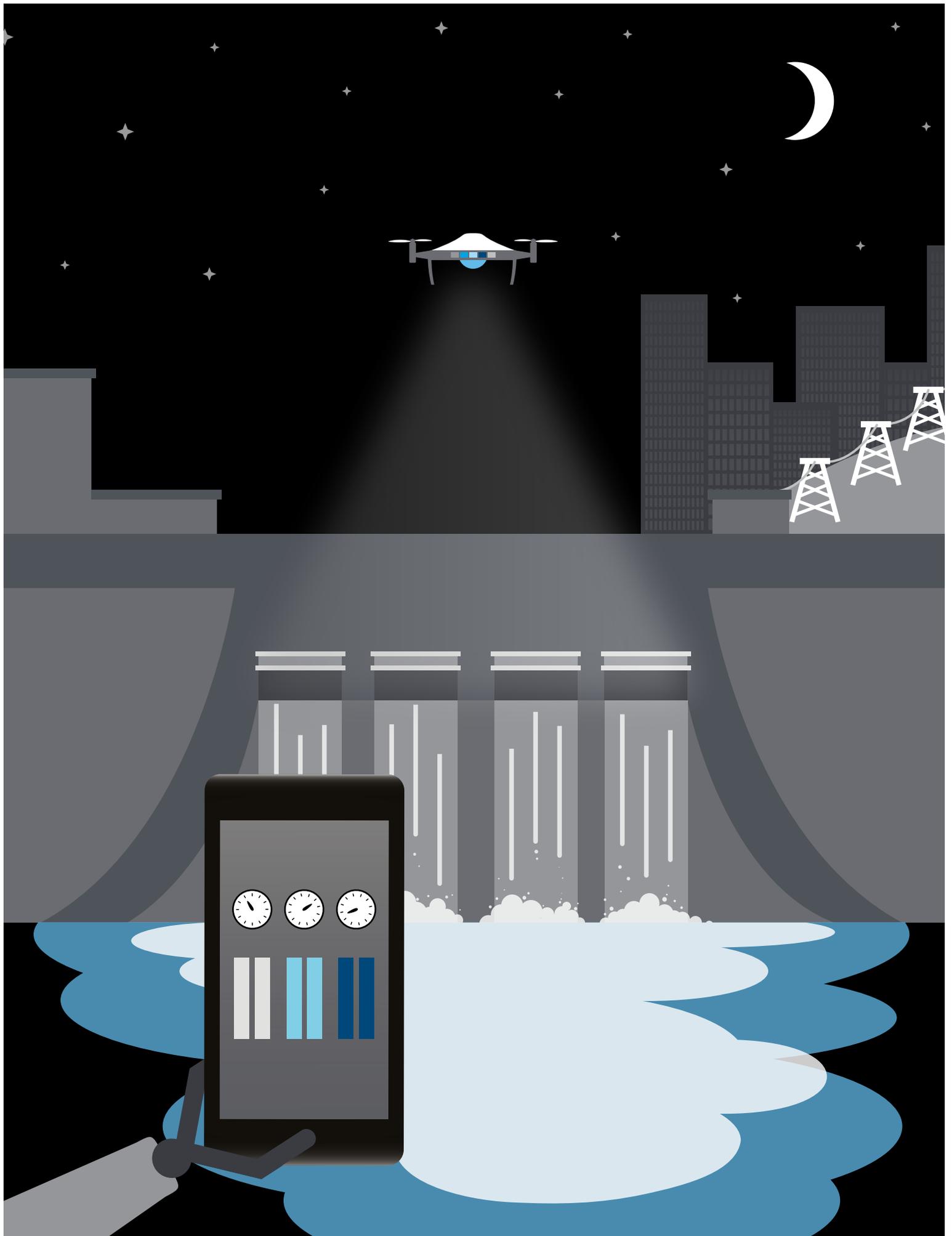
The conversation is growing because investors, especially institutional investors, are asking about it. Ten years ago, you would occasionally hear these questions. The questions are now being frequently asked, but the "answers" aren't easy to categorize. You can't put these issues into boxes because there's a highly qualitative aspect to them. I would say the assessment part is where we have a ways to go.

**Has taxation gotten more on the board agenda over the past few years?**

Tax is a big part of a board's agenda. The reasons include sweeping tax changes in the United States over the past 18 months or so, and charges companies had to take to repatriate assets. As companies became more global they realized they had cash in various jurisdictions; they needed to decide how to use it, and where to invest it, in a tax-efficient manner. Companies moving their headquarters to favorable tax jurisdictions has also become a concern. These conversations have been driven by changes in tax policy and increased globalization.

**What else should directors keep in mind over the long term?**

Good boards think long term about every issue and decision they face.





# The board and ESG

## Going long on the future of the enterprise

Discussions of environmental, social, and governance (ESG) matters have taken hold in mainstream media, government bodies, coffee shops, the food industry, clothing manufacturers, and boardrooms. With such high stakes, this is an area that organizations, and their boards, cannot afford to get wrong.

As overseers of risk and stewards of long-term enterprise value, board members have a vital oversight role in assessing the organization's environmental and social impacts. They are also responsible for understanding the potential impact and related risks of ESG issues on the organization's operating model. In light of these factors and stakeholder concerns, organizations are reimagining and enhancing their ESG positions. This is happening more in some regions (e.g., Europe) than in others, and it is more prevalent in certain sectors (e.g., consumer products, heavy industry). Shifting political winds also can affect these efforts. Since ESG issues began to move into the mainstream, the trend has generally been for organizations to pursue sustainable practices for the long term.

It can be challenging for boards to connect global issues, such as climate change, water scarcity, or human rights, to the organization's operations, strategy, and risk profile. But given that ESG concerns both influence and are influenced by operations, finance, risk, compliance, legal, human resources, and other considerations, leadership teams have ample opportunity to leverage ESG for the long-term good of the organization, its stakeholders, and society. It's an endeavor both management and the board need to undertake for the general betterment of those inside and outside the enterprise.

### The evolving ESG landscape: Trends and practices

ESG matters are finding their way onto boardroom agendas more frequently. As the scope of these and the debate surrounding them continue to expand, so do the board's oversight responsibilities. The following are among the key ESG-related trends:

- **Impacts are increasing and increasingly important.** Business activities have both positive and negative impacts on society. Negative impacts include their contribution to climate change and weather-related events, air and water pollution, ecosystem degradation, mistreatment of animals, human rights abuses in supply chains, and potentially unsafe practices and products. Many believe that most negative impacts related to human activities, such as climate change and biodiversity losses, are worsening. Among the most favorable trends is a decline in world poverty; global GDP has risen steadily in the past two decades. Business has also been credited with innovations, job creation, philanthropy, and other contributions. Some organizations have actively embraced and promoted "green" goals and aim to boost the "triple bottom line," which considers people, planet, and profits.
- **Transparency is the new normal.** Trends in ESG reporting indicate a steady move toward greater transparency. Standard-setting organizations, including a number of stock exchanges, have called for enhanced ESG disclosures. Civil organizations and the media regularly track and report on ongoing performance and specific events in terms of industrial accidents, environmental degradation, and impact on human populations. Social media



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has also become a force for ongoing transparency, and consumers increasingly want to understand what is behind the product they see on a shelf.

- **Reputation is an indispensable asset.**

As trust in institutions and the power of traditional advertising have diminished, organizations have come to realize that reputation constitutes a strategic asset and can be directly and indirectly influenced by ESG practices. Although reputation is often viewed mainly as an issue for business-to-consumer companies in developed countries, many business-to-business companies in all markets are affected by greater risks and heightened transparency requirements across the supply chain. In response, many companies are now prioritizing ESG factors internally and among their vendors. These organizations realize that a significant ESG event anywhere in the extended enterprise can damage their reputation.

- **The workforce cares.** Employees want to be proud of where they work and want its purpose, mission, and culture to reflect, or at least not oppose, their values. This is especially true of younger professionals. Corporate value statements and management's cultural messaging may mean little to these workers in the face of negative ESG impacts, which can compromise an organization's ability to attract talent. A favorable ESG profile and an absence of negatives can be an asset, particularly in areas where talent is scarce and competition is strong.

- **Business value is at risk.** ESG issues can take a long time to erupt into risk events. While many environmental risks, such as climate change and water scarcity, have been anticipated for a long time, others emerge rapidly. A recent example includes the plastic backlash that began a year ago, soon after the discovery of the

Pacific garbage patch and the subsequent media reporting. Not all ESG risks are long term. Depending on the business model, material and labor sources, evolving regulations, and stakeholder behavior, ESG matters can also present near-term threats to an organization's supply chain, reputation, and shareholder value. Consider the potential impact of child or forced labor in the supply chain, carcinogenic ingredients or conflict minerals in products, or major class-action suits launched over executive decisions or behavior. Given the potential impact on near- and long-term shareholder value, leaders must gauge the full range of factors that generate ESG risks and develop ways to address them.

It can be useful to think of ESG risks in terms of the organization's social license to operate. Unlike a legal license to operate, the social license to operate is granted, in part, by customers through their purchasing decisions. If your ESG reputation is tarnished or people associate your enterprise with global warming, water pollution, resource abuse, child labor, or poor working conditions, your business may suffer either a gradual or rapid decline in demand. Many consumers seek out companies known for sustainable practices and are willing to pay a premium for sustainably produced food and clothing or space in a LEED-certified building. Such consumers often represent a substantial, loyal, and affluent minority. Equally important, sustainable products are being brought to market at costs increasingly comparable to those of more traditional versions, a trend that we expect to continue.

Regulators tend to follow the public's concerns on ESG matters, although they also develop their own views. In general, the European Union has been the global leader in ESG policies, followed by North America

and Asia. Under Directive 2014/95/EU, as of 2018, about 6,000 EU companies must disclose their policies on environmental protection, treatment of employees, respect for human rights, anti-corruption and bribery, and board diversity. Lower and more variable regulatory demands in North America tend to generate practices driven by stakeholder expectations and individual companies' initiatives, with some organizations and jurisdictions pursuing aggressive programs. California will, as of 2020, ask the two largest US pension funds to consider disclosing material climate-related risks if it is in the shareholders' best interests.<sup>4</sup> ESG practices are also reaching new regions; for example, many Southeast Asian companies have boosted ESG efforts to bolster their reputations and their ability to do business in countries with stronger policies.

### **Investors look to ESG**

The ESG concerns of specific investors vary, as does their view of organizational responses, but all need information to help them make investment decisions. They want insight into management's posture on ESG topics and the associated issues and risks, as well as plans and responses. For example, institutional investors have become highly concerned with climate change, and many are voting their proxies, engaging management, and seeking clarity on management's and the board's positions in this and other areas. Engagement can help companies better understand which ESG topics their shareholders see as priorities.

Investors realize that ESG activities can have negative or positive financial consequences and they want to anticipate and account for the operational, regulatory, and reputational impacts of ESG issues. They see the link between ESG and the value of the business, but they cannot forecast value and factor in related risks without better ESG information.

It is in the organization's interest to provide robust ESG disclosures. First, these disclosures give investors information they want and need; when it is lacking, they may think the worst or simply invest elsewhere. Second, public disclosure allows businesses to demonstrate progress and benchmark their own practices and reporting. Finally, public disclosures put management in control of the ESG narrative. When investors do not receive ESG data directly from the company, they will turn to other sources for that information or an approximation of it. It's highly preferable for the organization to provide accurate data and develop the narrative context for its ESG practices to communicate the right message.

Unfortunately, even those companies that are working to enhance their disclosures often produce results that lack the relevance, transparency, and comparability that would really benefit stakeholders. Some have still not identified the most material ESG issues for their businesses. Most communicate aggregate information rather than reporting on specific geographies and lines of business; this high-level aggregation is of little help in comparing companies with different geographical footprints and different degrees of value chain integration. Investors would need further investigation and analysis to make those comparisons when they are even possible. While the trend has clearly been in the direction of increasing ESG disclosure, there's room for improvement on detail, transparency, and comparability.

Some financial institutions now consider ESG factors in their lending and investing decisions, with others moving quickly in this direction. Although these institutions might not have considered corporate customers' ESG profiles in the past, they now realize that ESG risks could affect those customers' future financial performance. They are scrutinizing these issues more closely when considering which companies and projects they will finance, particularly in light of climate-related issues, although concerns extend to other areas. This trend is strongest in Europe, where sustainability performance can influence what corporate customers will pay for a loan, which would not have happened years ago.

### Sources of guidelines

Boards, CFOs, and audit committees should be aware of organizations and initiatives that promulgate ESG reporting guidelines. Some of these include:

- *The Global Reporting Initiative* is a network-based organization committed to improving sustainability reporting; its participants include business, social, labor, and professional organizations. GRI's Sustainability Reporting Guidelines are widely used by large companies and set forth reporting principles, standard disclosures, indicator protocols, and economic, environmental, and social performance measures. The latest release stresses "material aspects" to help organizations identify issues significant to stakeholders.<sup>5</sup>
- The *International Integrated Reporting Council* promotes periodic, holistic reporting about value creation. The IIRC helps organizations consider how environmental strategy, governance, and performance can create value in the short, medium, and long term. The IIRC also strives for a reporting environment that promotes understanding of strategy, drives performance internally, and attracts investment.<sup>6</sup>
- The *Sustainability Accounting Standards Board* sets sustainability accounting standards for publicly listed companies in the United States for use in disclosing material sustainability issues to investors and the public. It is developing standards for more than 80 industries in 10 sectors by researching material issues, convening industry working groups to establish accounting metrics, and providing education on how to recognize and account for material nonfinancial issues.<sup>7</sup>
- The *World Federation of Exchanges*, a global industry association for exchanges and clearinghouses, published principles in 2018 to integrate a long-term perspective into financial markets to reduce socioeconomic and physical risks. While member exchanges are not required to adopt additional rules or recommendations on ESG disclosures, 39 of the WFE's 79 members have issued such guidance, and the new principles were greeted as a milestone by the United Nations Sustainable Stock Exchanges initiative.<sup>8</sup>

### Guiding the enterprise toward greater sustainability for the long term

Most leadership teams already see the need to identify and manage ESG impacts and risks. Boards have the responsibility to influence management to enhance the organization's approach to ESG. This is not just about public relations and branding, although those are valid considerations, nor is it merely a matter of ethical practices and having a positive organizational impact. It is also a question of business performance and long-term value. Almost by definition, sustainable practices aim to ensure that the organization creates and maintains value over the long term.

The business case for ESG generally begins with operational efficiency and risk reduction as primary goals and then extends to longer-term operational and organizational resiliency and sustainability.

To head the organization toward an increasingly robust approach to ESG, the board might also consider the following practices:

- **Request a formal ESG assessment.**

Senior executives and the board should be aware of all potential impacts, risks, and opportunities posed to the business by ESG concerns and be clearly informed of those that are most material for the future of the organization. An ESG inventory and formal risk assessment should extend beyond the organization and its internal operations, and it may be appropriate to engage external stakeholders. The assessment should cover the complete supply chain, the extended enterprise, and strategic considerations such as resource accessibility, usage, and sustainability; talent recruitment, engagement, and retention; financial performance and risk; and reputational impacts. The assessment should not only identify and rate all risks, but also consider how those risks interrelate at the enterprise level.

- **Urge management to engage with stakeholders.** Management must understand the ESG priorities of key

stakeholders—particularly investors, customers, employees, regulators, and business partners—and how they view the organization's performance. This information can be gathered and monitored through periodic surveys of specific stakeholder groups or across all stakeholder segments. It's best to have a formal process of ongoing stakeholder engagement at the management level, and in some cases to involve the board. For example, some companies develop a committee of representatives of key stakeholder communities to discuss ESG matters. Others will consult "critical friends" on sensitive ESG topics. Many also monitor their reputation in traditional and social media and work to address ESG concerns raised there.

- **Insist on high-quality internal ESG reporting.** The board needs to understand management's approach to ESG and its performance against relevant metrics. Energy use is an excellent starting point for many large organizations; other metrics may involve water use, especially in areas where it is scarce; critical metals; chemicals, plastics, and other materials; labor practices; climate and other environmental impacts; and extended enterprise practices. Coverage should extend to foreign, as well as domestic, operations. ESG events should be reported to the board in keeping with the organization's established risk-reporting procedures regarding type and magnitude. Developing a reporting protocol can be challenging, because this goes beyond financial and standard operating reporting. Either the board or specific directors should engage with management and external experts regularly to understand the interplay between ESG and the organization's operational and financial performance, goals, risks, and reputation. The board should also work with the CFO and other senior leaders to obtain data that is relevant and comparable from period to period.

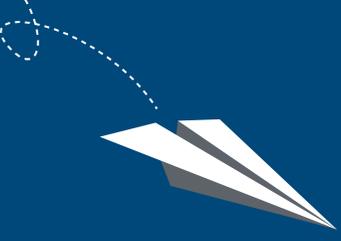
- **Encourage more proactive disclosures and goal setting.** Management should

be aligned on which facets of ESG are most important to the organization and adopt a method of reporting on related activities, risks, and opportunities. The organization should articulate clear and measurable goals on ESG issues so it can gauge progress over time. Gathering ESG data and developing an ESG reporting infrastructure now helps position the organization for a future in which the demand for this information will likely increase. Management should make ESG disclosure a priority, update disclosure practices based on changing standards and organizational practices, and maintain control of the organization's ESG narrative.

- **Establish specific ESG roles and responsibilities.** Once an organization has identified and assessed specific ESG impacts, risks, and opportunities and the data gathering, measurement, and reporting mechanisms are in place, management and the board are better positioned to set and pursue near- and long-term goals. Many large organizations have appointed a chief sustainability officer, while others have given the CEO or other C-suite executives explicit ESG responsibilities. From a board perspective, ESG is most often overseen at the full board level or by the board's strategy or risk committee. The audit committee should also initiate or strongly support efforts to provide high-quality ESG assurance to the board, or to the primarily responsible board committee.

Arguments boards make to encourage management's ESG efforts typically involve business disruption, regulatory compliance, and reputational risks. These arguments are compelling in the absence of strong regulatory imperatives or in the presence of weak ones.

In keeping with recent trends, ESG regulation is expected to continue to strengthen, as is the interest that investors, customers, supply chain partners, civil organizations, and the media have in ESG policies that have a positive impact on the communities they touch.



## Questions for directors to ask

- Which ESG issues most concern our stakeholders? What steps is management taking to understand and monitor stakeholders' concerns?
- How is management integrating ESG considerations into the business strategy? Which ESG risks and opportunities have been identified in both the near and long term and how is management addressing and periodically assessing them?
- What process does management have for identifying ESG risks and opportunities? What process is in place to integrate ESG considerations into strategic planning and decision making?
- How satisfied are we with the ESG information we're receiving? What information should we be receiving that we are not? What type of assurance would improve our line of sight into our organization's ESG practices?
- What is the best way for us, as a board, to increase our internal and external engagement on ESG? How often should we discuss ESG among ourselves and with management? How can we make those discussions more robust and productive?
- How are we keeping pace with investors' expectations regarding ESG disclosures and reporting? How do we compare with our peers in this regard? What is the best course for our organization to pursue when it comes to disclosure?



# A conversation with Laura Cha

Laura Cha is a member of the Executive Council of the Government of Hong Kong, chair of Hong Kong Exchanges and Clearing Ltd and a member of the Financial Leaders Forum.

Laura is also the non-executive deputy chair of The Hongkong and Shanghai Banking Corporation, an independent non-executive director of HSBC Holdings plc and The London Metal Exchange, and serves as a non-executive director at Unilever plc.

Furthermore, Laura is a senior international advisor to Foundation Assets Management Sweden AB, a member of Sotheby's International Advisory Board, vice chair of the International Advisory Council of the China Securities Regulatory Commission, and a director of the World Federation of Exchanges.

Laura became the first and only person outside Mainland China to-date to join the Central Government of the People's Republic of China at the vice-ministerial rank when she was appointed as vice chair of the China Securities Regulatory Commission in January 2001. She served in that position until September 2004. She also worked for the Securities and Futures Commission in Hong Kong from 1991 to 2000, becoming its deputy chair in 1998. She was also chair of The Financial Services Development Council of Hong Kong from January 2013 to July 2018.

## What is your view on short-termism versus long-termism at the board level?

I would say that short-term and long-term thinking are interrelated, and you cannot really separate them. The short term actually constitutes the first stage or the first few stages of your long-term strategy. The long-term view is critically important because that forms the backdrop of every company's strategy: its direction and where it wants to be in the future.

However, if you set too long of a time horizon, it can become unrealistic. These days, short term should cover one to three years whereas long term would be closer to five years. A decade or two ago, medium term would have been five years and 10 years would have been long term. With technology and the whole world changing so rapidly, organizations can develop core long-term principles and values while adapting a shorter-term strategy. Of course, time horizons will differ by industry.

## Are boards ready for Industry 4.0?

It is hard to gauge readiness because it differs by industry, but boards must be prepared. Being prepared means that you have thought through the issues and the organization is prepared to adapt. Given the prevalence of technology disruption, boards need continuous education in this area and need to stay abreast of the impacts, risks, and opportunities that technological changes pose to their respective industries.

## How does boardroom diversity impact its preparedness for the long term?

Preparedness means knowledge of the current issues and their potential impacts.

Diversity will help, because having various perspectives will enrich the discussion and debate. It's almost a given these days that you need diverse viewpoints, which makes the composition of a board so important. But being prepared goes beyond the diversity characteristics of gender and age. Being prepared is more about having a board that is well educated on the potential issues and impacts.

## How can boards plan for the long term during an uncertain and volatile period?

It depends. For example, early in 2018 the situation on the Korean peninsula made headlines. In this case, a consumer goods company likely had a different response than a financial institution. If a consumer goods company had a large market in South Korea, they had to consider the impact on its markets and customers. Meanwhile, a goal for a financial institution might be to reconsider its risks in Asia. At the time, it all seemed very real, yet a few months later the risk seemed to have been defused. So, whether a board should take action depends on the situation, the issue, and the organization's industry.

At the securities exchange, we understand that market volatility and various crises will come and go, and that there is little we or our board can do about that. On the other hand, systemic preparedness will ensure that our systems and operations are resilient and are able to handle unexpected situations and volatility. That is what we strive for, whether the situation is geopolitical or something else. Each issue should be considered and addressed individually.

The long-term view is critically important because that forms the backdrop of every company's strategy: its direction and where it wants to be in the future.

**What type of strategic plan do you communicate to your investors?**

Our next three-year strategic plan will be launched in the first quarter of this year. Many organizations have useful ways of communicating their plans to investors, with investor relations generally playing an important role in that.

**Do boards often hear from investors on their short- and long-term views?**

In Hong Kong, the situation is slightly different from other markets as there are a lot of small investors and a significant amount of retail participation in the stock market. One can expect to hear many viewpoints from various investors, but most of our institutional and retail investors fall broadly into two groups. One group mainly wants to know that there's a sound dividend policy with dividends declared every year. The other group is not focused on dividends and may not want dividends declared. This group appears to be focused more on the long term. These investors realize that the organization probably has a long-term strategy that will enable it to declare a dividend further into the future.

**What long-term concerns tend to be on the minds of institutional investors?**

ESG is high on their agenda, and I've seen this building up for a few years now. It's definitely driven by the buy side. There are many ways in which an organization can define responsible corporate citizenship. I have seen some sovereign funds that have said they will no longer invest in fossil fuel industries or in the tobacco industry. That emanates from ESG concerns. Corporate social responsibility will remain high on the board's agenda, with the environment being an increasingly important element of ESG.

**What would you say are the most important long-term aspects of ESG for Hong Kong-based companies?**

Again, it depends on the industry, but I would say that the social component is one that most Hong Kong companies are embracing. This tends to cut across all industries and can take the shape of caring for the community. As a securities exchange, we work to promote financial literacy. Governance is also a very important aspect of ESG.

**Mainland China is considering adopting mandatory ESG rules. How will other countries, more specifically Hong Kong, respond?**

Yes, they are ahead of Hong Kong in that area. We are looking into their proposals and into ways to expand on our requirements in this area.

**What are the long-term focus areas for Hong Kong company boards?**

Board diversity is an important issue—it has been for some time—and progress made has been slow. If you look at gender diversity on Hang Seng Index company boards in particular, the proportion of women serving on boards has risen from around 10 percent to 11 or 12 percent in recent years. This is an area that needs improvement relative to other markets. Beyond diversity, there are other focus areas. For us, our long-term relationship with the Mainland Chinese markets is quite important. Meanwhile, technology is of course an overriding issue for all exchanges and for all companies.





# Tax strategy for the long term

## Is your company getting it right?

Once considered just another part—and cost—of doing business, tax has become a high-priority agenda item for both the C-suite and the board. Even amid decreasing corporate income tax rates in the United States, the sheer number and range of changes in government tax policies warrant close attention, certainly for senior leaders of multinational corporations (MNCs) and for most enterprises doing business internationally.

Concerns now extend well beyond achieving financial targets to include managing reputational risk, weathering increased scrutiny from media and activist organizations, and addressing the impact of tax on everything from business models to investor communications. Stakeholder interest in tax matters has also increased. Given this heightened profile, organizations should be consciously shaping their tax strategies and involving senior executives, the board, and more specifically, the audit committee in the process, along with the finance and tax functions.

The pace of change in government tax policies adds complexity to this inherently technical area. Those policies remain a work in progress as tax authorities grapple with the effects of digitalization, new business models, new methods of accessing talent, and globalization. When you consider that today's tax codes rest on frameworks formulated more than 100 years ago, the magnitude of the changes and their potential to have a long-term impact become clear.

### What's driving change?

The impetus for many recent changes can be traced back to the 2008 global financial crisis, which forced a number of countries to introduce significant budget-cutting measures. At the same time, there was a growing perception that MNCs were using tax planning to erode the corporate tax base because international tax law had not kept pace with the increasingly globalized and digitalized economy. The G20/Organisation for Economic Cooperation and Development (OECD)'s Base Erosion and Profit Shifting (BEPS) project<sup>9</sup> set out to address these concerns by increasing transparency and curtailing international tax planning. This led to unprecedented legislative tax changes around the world, a number of which are outlined on page 35.

Technology stands among the primary drivers of change in tax policy, as it does in many facets of business. Tax practices within and between countries were developed when Industry 4.0, artificial intelligence, cryptocurrencies, blockchain, data analytics, and robotics were barely imaginable. Rapid adoption has left governments playing catch-up even as those technologies and the practices they enable continue to evolve.

Consider the challenge that the digitalization of business poses with respect to tax matters. Taxation, historically and of necessity, seeks out and draws from value; that is, global transfer pricing systems generally aim to tax value where it is physically generated. Therefore, business



**Albert Baker**  
Tax Policy leader  
Deloitte Global

# Agreement on how digitally developed value and digital transactions should be taxed has proven elusive.

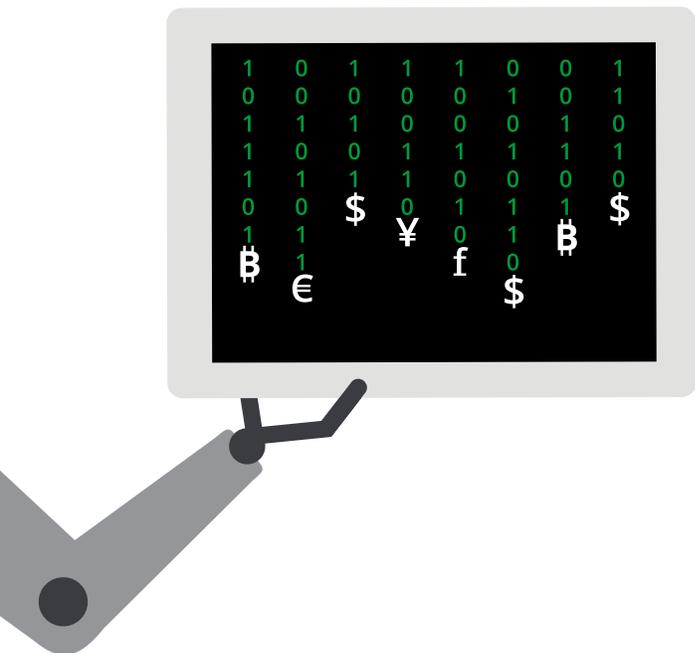
models that generate value from data prompt questions: Does the value that should be taxed reside in the data itself? In the processes that analyze or otherwise add value to the data? In selling the data? In the technologies that house and manipulate the data? And where, exactly, are each of these processes, activities, or technologies physically located?

The OECD has been seeking consensus on these fundamental questions of how value should be defined and taxed. Unfortunately, agreement on how digitally developed value and digital transactions should be taxed has proven elusive. No fewer than four views of the matter have emerged: Some countries believe that current tax law can address digital matters. Others believe that specific legislative changes are needed to address them. Still others believe that the issue extends beyond digital considerations and that a broader revision of tax laws is needed. And a fourth group has yet to decide which approach is best.

As the OECD continues its work in this area, the importance of reaching a global consensus cannot be overstated. Each country taking unilateral action could result in chaotic complexity, double taxation, and impaired cross-border trade and growth. As of this writing, the OECD was contemplating three approaches:

- A “digital permanent establishment” with allocations of profits made to jurisdictions based on criteria such as number of users in the member country
- A return to jurisdictions-based approaches, taking into account the value of marketing intangibles
- A minimum tax approach, along the lines of the US Global Intangible Low Taxed Income (GILTI) regime, coupled with a secondary approach applicable to companies parented in jurisdictions without a corporate income tax or that do not adopt the minimum tax.

The latter two approaches would apply to all businesses and not just those operating in the digital economy.



## Unprecedented change in taxation

The OECD's BEPS project has introduced a number of actions guided by the principles of coherence, substance, and transparency. Initiated by the G20 in 2012 and now expanded to 124 countries, the BEPS project stemmed from perceptions by some that many MNCs were not paying their "fair" share of tax and were engaging in legal tax arbitrage.

Some of the actions now being implemented include:

- Global Country by Country Reporting, which calls for detailed reporting of corporate taxpayers' foreign operations to be shared with tax authorities around the world, thus increasing transparency. Generally, 2018 is the first year for tax authorities to exchange information.
  - Global transfer pricing guidelines with more detailed global and country reporting and a focus on allocating income to those countries where activities are performed and economic substance<sup>10</sup> is present. Generally, 2017 was the first year of reporting, but the new guidelines have been applied by many countries to open cases dating from 2015.
  - A multilateral treaty instrument, signed by 84 countries as of November 2018, to swiftly implement the BEPS-related changes into existing treaties and prevent using treaties for tax avoidance. This initiative is expected to impact over 2,000 bilateral tax treaties starting in 2019.
  - Automatic global sharing of local-country tax rulings among tax administrations, applicable from 2016 and in the European Union from 2017.
  - A harmonized global approach to patent box incentive regimes, generally applicable in 2016 through 2021.
  - Eliminating mismatches in country tax laws applicable to taxation of cross-border hybrid instruments and entities; countries are implementing anti-hybrid rules into local legislation with various effective dates from 2017.
  - Restricting the deductibility of corporate interest expense starting in 2019 in the European Union, 2018 in the United States, and 2017 in the United Kingdom.
  - Greater domestic taxation of offshore income, known as controlled foreign corporation income, effective on various dates and in 2019 in the European Union.
- The following specific developments have occurred beyond the BEPS project:
- EU Anti-Tax Avoidance Directives 1 (effective in 2019) and 2 (effective in 2020–2022) implementing certain measures described above and further measures, including a General Anti-Abuse Rule; a tax intermediaries directive to increase reporting requirements as of July 2020, with some retroactive application; and European Parliament TAX3 Committee work related to financial crimes, tax evasion, and tax avoidance.<sup>11</sup>
  - A 2018 EU proposal (not yet adopted) to tax digital companies using a temporary measure pending global consensus in this area: a 3 percent tax on specified sources of gross income.
  - US tax reform in 2018 reduced the federal corporate rate from 35 to 21 percent and introduced exemptions for dividends from foreign subsidiaries and other measures, including:
    - A Global Intangible Low-taxed Income regime that taxes earnings above certain thresholds in foreign subsidiaries on an accrual basis at an effective rate of 10.5 percent for 2018 through 2025 and 13.13 percent thereafter
    - A Foreign-Derived Intangible Income regime that taxes foreign income above certain thresholds at 13.13 percent for 2018 through 2025 and 16.41 percent thereafter<sup>12</sup>
    - A base erosion and anti-abuse minimum tax, which offsets the benefit of certain payments to foreign-related parties and ensures that the US payer is subject to at least a 10 percent liability (5 percent for 2018 under certain transitional rules) on taxable income, computed without regard to the related-party payments.
  - Inspired by the 2010 US FATCA, the Common Reporting Standard (CRS)/Automatic Exchange of Information calls for financial institutions to automatically advise a customer's country of residence of any accounts opened; 49 countries adopted the CRS in 2017, another 52 in 2018, and seven more are slated to do so in 2019–2020.<sup>13</sup>



Deloitte conducted its fifth annual BEPS survey in 2018 to gauge MNCs' views of the evolving tax landscape.<sup>14</sup> Key findings of this survey of 447 participants from 39 countries include the following:

- 86 percent agree or strongly agree that tax structures are now under greater scrutiny by tax administrators than a year ago.
- 49 percent agree or strongly agree that country tax authorities are becoming increasingly aggressive in tax examinations.
- 91 percent believe that additional transfer pricing reporting requirements resulting from BEPS will substantially increase their corporate tax compliance burden.
- 48 percent are concerned about the lack of domestic guidance on BEPS-related legislative changes, and only 21 percent expect consistency in interpretations of new transfer pricing guidelines by tax authorities in various countries.

These responses highlight the need for organizations to take a strategic, multidisciplinary approach to changes resulting from tax-related government initiatives. In the past, this might not have required the attention of senior management and the commitment of organizational resources, but the new environment now requires both to support long-term success.

The US Supreme Court case of *Wayfair* versus South Dakota epitomizes the rapid change in the tax arena and its impact on business models. In this case, the Supreme Court determined that simply selling into a state may constitute nexus in the state for a company and thus create a tax obligation to that state. This decision has prompted many organizations to revisit their taxation practices in individual states. In the past, they may not have had sales tax or other tax obligations in a state where they did not maintain a physical presence.

The BEPS project has focused on increasing transparency and curtailing international tax planning. The work regarding the digital economy is focused on reaching agreement among countries on the allocation of taxing rights. Consensus continues to be a challenge across the European Union and globally; some countries have already introduced unilateral measures to tax the digital economy and more intend to do so, potentially leading to double taxation.

While some base-broadening initiatives will result in an increase in tax liabilities, governments are striving to attract and retain investment and create jobs through reductions in corporate tax rates, accelerated depreciation allowances, and other incentives. The average corporate tax rate in OECD countries fell from 32.5 percent in 2000 to 23.9 percent in 2018.<sup>15</sup>

Changes in tax policy present opportunities for corporate leaders, including the board, to take a more proactive approach to tax policy discussions. Policy makers generally seek business leaders' input and certainly consider it. They realize that organizations understand their businesses and the operational and financial impacts that changes in tax policy can have on individual companies and entire industries. Business leaders are positioned to help policy makers visualize what would and would not work from a practical business and industry

perspective, so it's useful for them to share those perspectives with government in the early stages of policy development and thereafter.

Active engagement with tax policy makers by executives and board members can also help gauge where tax policy may be headed. The board should confirm that management is actively assessing potential legislative developments at the regional, national, and provincial or state levels and considering alternative responses. Inputs to scenario planning should take into account potential changes to tax laws and their likely impacts.

Deloitte research suggests that changes in tax policy are having a significant effect on organizations (see sidebar). As in any situation characterized by rapid change, competing interests, and unsettled rules, uncertainty prevails. And uncertainty means risk.

#### **Tax-driven risks**

Risks resulting from the foregoing developments can be broadly characterized as financial risk, disclosure risk, and reputational risk.

Financial risk arises when tax authorities could prevail in challenging an organization's position, with potential impacts on cash flow, earnings, and other accounts. If a material transaction is challenged and the company's position is not sustained, financial consequences ensue.

Disclosure risks may arise around how clearly the sustainability of the organization's tax policy or effective tax rate is conveyed and uncertainties related to tax assets and liabilities.

Tax-related reputational risk varies in its forms and across organizations. For example, the media or activist groups may portray a company as underpaying taxes, not paying its fair share, paying lower rates

than private individuals or smaller businesses, or avoiding taxes.

Management should conduct assessments of tax-driven risk and associated risk-return tradeoffs and establish explicit tolerances. Senior executives and the board should discuss these risks and tradeoffs and approve the related risk tolerances. These practices are occurring more frequently given that these issues often impact the broader organization and thus fall within the board's risk oversight responsibilities.

Beyond enterprise-specific risks, there are macro-level risks if tax authorities fail to develop a coordinated approach in this new environment. There's significant risk of highly uncoordinated, unilateral action being taken around the world, which could lead to multiple levels of taxation without offsetting relief. That would almost certainly have a negative effect on specific businesses as well as the global economy.

As part of its risk oversight responsibilities, the board must understand these tax-related risks and confirm that management has recognized and addressed them. The board's involvement with tax strategy also extends beyond that, particularly regarding longer-term considerations.

### **Overseeing tax strategy, policy, and risks**

Given digitalization and the increasing role of technology in the future of business, tax matters will extend well beyond near-term financial, reporting, and reputational impacts. The board should ascertain that management has prepared the organization not only for immediate tax changes but also for its intermediate- and long-term impacts. Many boards include this language in their audit committee charter.

Tax considerations are rarely the sole factor in a strategic business decision. Yet they should be factored into decisions involving technology platforms, the control environment, compliance systems, and assurance activities, as well as those involving new business and talent models, new markets, and all third-party relationships. These areas present both opportunities and risks to be analyzed from a tax perspective, even though tax

will generally not be the key determinant in the business decision.

The board should also consider the following specific issues that can be influenced by tax matters:

- **Business strategies and models:** Although business strategies and models should not be determined solely by tax policy, changes to the tax strategy should be considered. This is particularly true of marginal projects or those in which depreciation or the deductibility of expenses are affected. However, because taxes follow business models, it is important to analyze tax-related risks and opportunities. More change can be expected as legislation and litigation occur in countries and as disputes between countries are settled. Changes in trade policy, including increased customs duties, can also have a dramatic impact on global supply chains.
- **Systems and technology:** The board should confirm that management has prepared the organization's accounting and financial systems to accommodate changes in tax reporting, payments, data collection and analysis, and other needs emanating from changes to jurisdictional tax policies and the organization's tax strategy. Management should prepare the organization to address future tax changes, which can be expected in response to ongoing digitalization and political pressure.
- **Reputational considerations:** Tax strategy should be considered by management and the board in the context of overall reputational risk management. Senior management and the board need to understand the potential reputation risks associated with the organization's tax strategy. Although an organization's tax function should play a significant role in informing the board, reputational risk should be assessed through an organization-wide lens.
- **Talent models:** Issues involving employment taxes, employee income taxes, and taxes on independent contractors may arise, particularly as the gig economy, crowdsourcing, and talent mobility continue to increase—the notion of taxing robots has even been proposed. As

tax laws change, more robust support from the human resources and tax functions may be needed to handle the complexities of employment taxes and, in cases of foreign employees or locations, home-country/host-country income tax issues. Given the widespread use of alternative staffing models, management should closely monitor employee classification criteria, such as varying definitions of independent contractors and part-time employees.

- **Reporting and disclosures:** The increasing emphasis on transparency should prompt the board to work with management to assess voluntary disclosures regarding tax strategy with an eye toward investors and other interested parties. For example, management might discuss the organization's structure and its tax implications or the board's role in contributing to the government's tax policy and any related consultations. The company might disclose all taxes it pays beyond income tax to give the public a clearer picture of its total contribution to the governments and societies of the countries where it operates. Management's goal should be a sustainable tax strategy supported by technology, compliance, reporting, and assurance systems that can accommodate numerous changes in reasonable time frames at reasonable costs. In terms of reporting and disclosures, boards should encourage management to position the organization to proactively respond rather than to react to change.

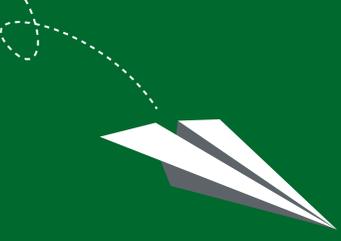
The board needs a clear line of sight into tax developments and management's responses. This includes understanding the organization's tax history, including the changes to past practices

and their impact. This information should be compiled and delivered to the board so it can familiarize itself with the organization's tax audits and the outcomes of any tax litigation. Historical matters can be conveyed to new board members in their orientation materials.

As a practical matter, many boards rely on the audit committee to keep them informed about the organization's tax positions and developments. However, if the board perceives little change in the reporting methodology and disclosures related to tax, it may be time to raise the matter with the audit committee or for the audit committee to do so with the tax, finance, and internal audit functions. Few large organizations remain untouched by the ongoing upheaval in tax policies.

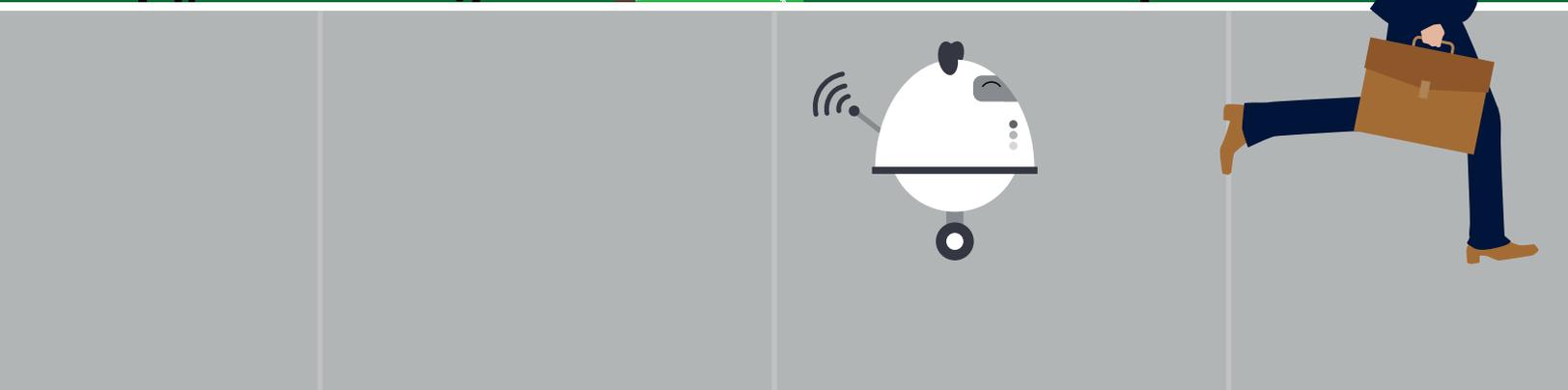
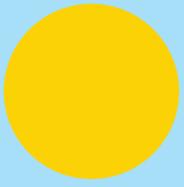
In this rapidly changing and highly technical area, tax expertise in the boardroom will vary significantly or, in some cases, may be lacking. External expertise in the form of written briefings or live presentations on tax changes and their potential impact can be highly valuable to both the audit committee and the full board. The full board should now consider discussing tax regularly to keep abreast of legislative developments and the organization's responses.

As in many areas that were once seen as relatively static, tax strategy and the related technology, administrative, and risk management infrastructure must now be reviewed more frequently, in greater detail, and at higher levels of the organization than in the past. Considering the long-term impact that tax strategies and policies can have on an organization, proactive engagement by the board is clearly warranted.



## Questions for directors to ask

- How is our organization's tax strategy aligned with our business strategy? Where do they fail to align? How can management better integrate the two, particularly in terms of long-term tax strategy?
- What financial, reporting, and reputational risks does management associate with our tax strategies? What has management done to evaluate and address these risks and any associated tradeoffs in the short and long term?
- What tax-related expertise is available on the audit committee and board? How can we augment resources in areas where we may be lacking sufficient or specific expertise?
- How can we keep abreast of changes in the government's tax policy and their potential short- and long-term impact on our organization and its operational and financial performance?
- How is management preparing our organization to address the operational and financial impacts of proposed changes to government tax policy? What has been done so far? What remains to be done?



# Conclusion

## Act now for long-term results

Every board member, and especially every board chair, is facing a clear question: How should I exercise leadership in this disruptive and unpredictable environment?

A shift toward long-termism, as opposed to the short-termism that has often dominated corporate thinking and behavior, is one answer. Virtually every decision involving the board holds long-term implications. But routine matters and urgent distractions continually focus board members' attention on the short term—short-term earnings, near-term performance, immediate impacts, and unfolding crises—often pushing long-term concerns to the end of the agenda.

Paradoxically, a tight focus on the short term can prompt leaders to dismiss new strategies, technologies, and methods as fads or as lacking value when they actually represent the future. Short-term thinking can lead to inertia and undermine growth and performance. Why develop a product that may be superseded in six months? Why invest in employees who may leave next year? Why build capabilities when they can be so perishable?

In the face of such doubts, current demands and an emphasis on speed can blind management to long-term strategic and operational considerations. Similarly, investors' demands for near-term returns can prompt efforts to generate quarterly earnings while neglecting or even undermining the drivers of long-term value. Government actions can elicit knee-jerk reactions rather than considered responses. A short-term focus can result in diminished social responsibility, degradation of resources, and failure to upgrade technology, plants and equipment.

As stewards of long-term enterprise value and ambassadors of the organization to the larger society, boards and their chairs are responsible for resisting short-term forces and keeping the focus on the long-term good of the organization and its stakeholders. We've discussed four areas that organizations and their boards should pay close attention to in 2019: Industry 4.0; investor engagement and activism; ESG policies; and tax strategy. Boards might emphasize a broader shift toward a more long-term focus by examining the long-term aspects of every area of responsibility, every major decision and investment, and all critical policies.

The business environment is in constant flux—that's undeniable. Boards not only need to change the way they approach these challenges, but also to look inward. What skills and attributes do directors and the board chair need today to exercise leadership, good governance, and oversight? What will they need in five years? In 10? In 20? What constitutes the board of the future and what qualifications will be needed to chair that board?

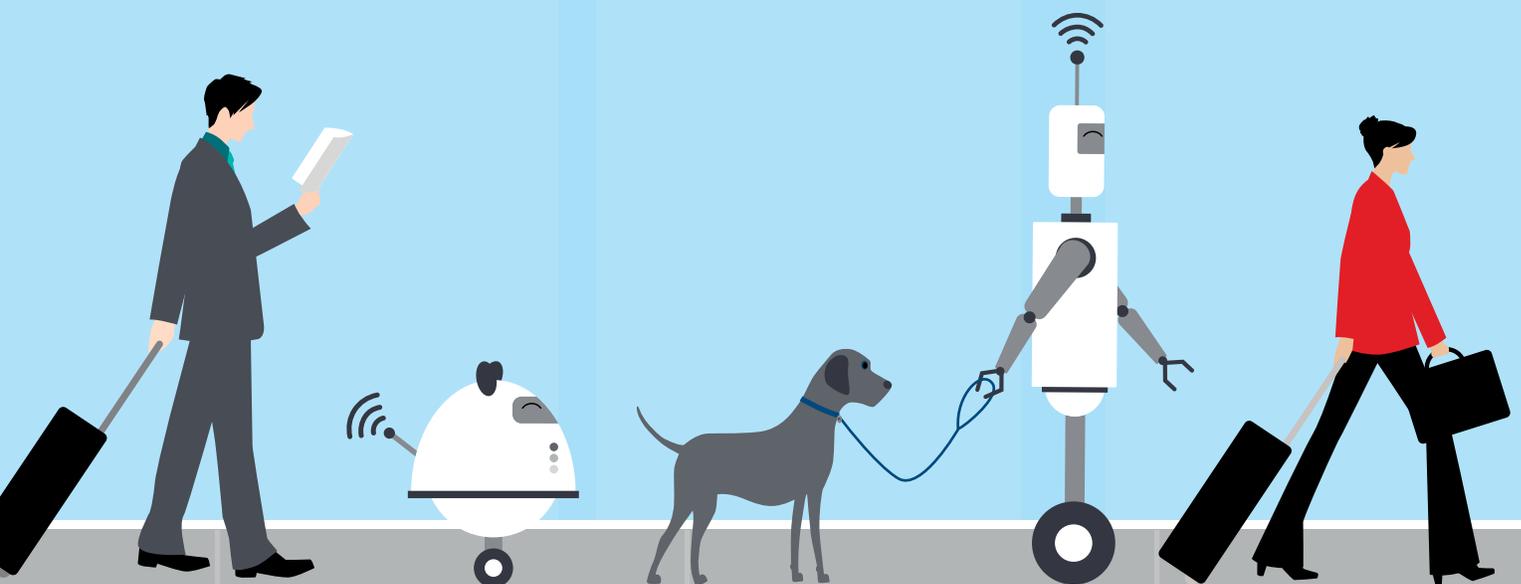
Recent research<sup>16</sup> suggests that boards can prepare for the future by:

- Developing greater agility and responsiveness and adapting quickly to changes in the competitive landscape and the larger socioeconomic and political environment
- Taking the lead in articulating the broader purpose, role, and impact of the business relative to established structures, norms, and values
- Embracing diversity of thought, including disruption in the business and the boardroom, while bringing relevant perspectives and expertise into decision making



**David Cruickshank**  
Deloitte Global Chairman

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- Engaging in continuous education to stay abreast of new developments in technology, innovation, strategy, risk oversight, and other areas
- Demonstrating added value to senior management and other stakeholders and making contributions to the wider organizational ecosystem
- Engaging in independent evaluations to improve the performance of boards and individual directors.
- Humility and the ability to create space for reflection, partner with the executive team, and make challenges constructively and privately without stifling leadership's creativity and drive
- An appropriate understanding of the business and competitive landscape, along with needed technical knowledge of the business and its evolving environment.

Strong leadership by the board chair will be needed. The same research identified the following skills, characteristics, and success factors as being vital for the chair of the future:

- Strong emotional intelligence and influencing skills and the ability to listen carefully, work with groups of diverse individuals, and manage increasingly complex and vocal stakeholders
- Agile and curious mindsets with a propensity to scan the horizon for developments and monitor for possible disruptors

Like the organization of the future, boards of the future will be shaped by decisions and actions undertaken in the present. Boards have the opportunity and the responsibility to see that current activities lead to long-term betterment. In a very real sense, long-termism begins with the board and the board chair. While business will become increasingly dominated by technology, artificial intelligence, and robots in the decades ahead, it will be the human decisions that will shape the future.



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# Resources

Want to dig deeper? We've selected the following Deloitte publications to help you plan for the long term.

## **Long-term value creation: Understanding the fourth industrial revolution**

[Canada's AI imperative: From predictions to prosperity](#) (Deloitte Canada)

[Digital disruption: Meet the Fourth Industrial Revolution head-on](#) (Deloitte Canada)

[Germany's Digital Hubs: Geography of the Tech Talents](#) (Deloitte Germany)

[Industrie 4.0 Studie 2019: Wie meistern CXOs den Wandel?](#) (Deloitte Germany - in German)

[Deloitte Review: Navigating the future of work: Can we point business, workers, and social institutions in the same direction?](#) (Deloitte Global)

[Embracing digital risk in the age of Industry 4.0](#) (Deloitte Global/Forbes)

[How leaders are navigating the Fourth Industrial Revolution: Our latest survey of Industry 4.0 readiness](#) (Deloitte Global)

[The evolution of work: New realities facing today's leaders](#) (Deloitte Global)

[The Fourth Industrial Revolution is here—are you ready?](#) (Deloitte Global)

[The Fourth Revolution is now: are you ready? Future of operations](#) (Deloitte Global)

[The robots are waiting: Are you ready to reap the benefits?](#) (Deloitte UK)

[On the board's agenda | US: Industry 4.0](#) (Deloitte US)

[On the board's agenda | US: Not if, but how: Evaluating the soundness of your digital transformation strategy](#) (Deloitte US)

## **Investor engagement and activist shareholder strategies**

### **What the board needs to know and do for the long term**

[Be your own activist: Developing an activist mindset](#) (Deloitte UK)

[Hearing the stakeholder voice: Effective stakeholder engagement for better decision making](#) (Deloitte UK)

[CFO Insights: Activist shareholders: How will you respond?](#) (Deloitte US)

## **The board and ESG**

### **Going long on the future of the enterprise**

[2030 Purpose: Good business and a better future: Connecting sustainable development with enduring commercial success](#) (Deloitte Global)

[On the board's agenda: Sustainability and the board: What do directors need to know in 2018?](#) (Deloitte Global)

[On the board's agenda | US: The board's role in corporate social purpose](#) (Deloitte US)

### **Tax strategy for the long term: Is your organization getting it right?**

[Canadian Tax Alert: US tax reform – Financial reporting considerations](#) (Deloitte Canada)

[Canadian Tax Alert: US tax reform – Impact on M&A and the private equity industry](#) (Deloitte Canada)

[Verrechnungspreise – linke Tasche, rechte Tasche?: Miteinander verbundene Unternehmen müssen strenge Regeln beachten, wenn sie interne Dienstleistungen oder Lieferungen verrechnen](#) (Deloitte Germany – in German)

[2018 BEPS global survey](#) (Deloitte Global)

[Tax governance in the world of Industry 4.0: Adapting global tax regulation for connected enterprises](#) (Deloitte Global)

[The global tax reset: Summary results of the 2018 annual multinational survey](#) (Deloitte Global)

[Reshaping the code: Understanding the new tax reform law](#) (Deloitte US)

### **Further reading**

[Directors' playbook: The future of work](#) (Deloitte Australia)

[Chair of the future: Supporting the next generation of business leaders](#) (Deloitte UK)

[Governance in focus: On the board agenda: The 2019 reporting season](#) (Deloitte UK)

# Endnotes

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