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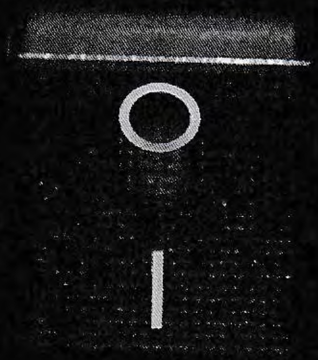
IoD & MinterEllisonRuddWatts, 2019



Always on duty

THE FUTURE BOARD

Institute of
DIRECTORS
NEW ZEALAND

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MinterEllison
RuddWatts

Contents

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Foreword

Boards have a critical role in leading sustainable success for business and society – but they are under pressure.

Boards have to be across a staggering array of complex and diverse issues. They also need to be responsive to ballooning stakeholder demands and expectations. New laws targeting directors personally, active regulators, and the rise of litigation funding are also adding to the load. However despite significant change in the operating environment, including disruption to many business models, boards are operating in much the same way they always have. This includes meeting periodically according to an annual work plan and relying on static information and presentations from management.

This traditional operating model is coming under increasing pressure. Many boards are now facing a time dilemma. They are weighed down by often voluminous board papers, compliance and risk, without sufficient time to discuss and debate critical strategic and performance issues. It's vital that we consider the cumulative effect of these and other emerging issues and what they mean for the future board.

The future board could look significantly different. Technology has the potential to fundamentally change the way boards meet, breaking down global barriers with virtual reality, holoportation and instant voice translation. Technology should also help transform the way boards operate to ensure directors are more informed and equipped to monitor organisations and make decisions. Artificial intelligence in particular is expected to play a greater role in augmenting board decisions especially with real time data and analytics and this may lead to a revolution in reporting.

As we accelerate into an exciting, challenging and unpredictable future, there will need to be steady hands at the helm. Savvy, committed, ethical and inspired directors who take their roles seriously will always be in demand and essential in leading and guiding organisations into the future.

Tomorrow's directors will continue to be responsible for the strategic and overall direction of organisations and not the day-to-day operations. Directors will still need to be future-focused, adaptable and equipped to create and protect value. More time will be spent outside board and committee meetings developing a deeper understanding of the business, closing the information gap with management. Rising stakeholder expectations will also drive greater board engagement especially with employees, shareholders, regulators and customers. Directors will work more collaboratively with each other and with management, continuously learning. We can expect the need for new board and director competencies.

Tomorrow's directors will be constantly learning – always on duty.

About this paper:

This discussion paper explores trends, challenges and opportunities about how boards may evolve and operate in the future. We also include insights from research carried out specifically for the paper in July and August 2019, comprising a short online survey and questions to directors on specific topics. We thank all of the directors for their valuable contributions.

The focus of this paper is mainly on boards of listed companies. The pressure on them is particularly acute given their public nature, diverse shareholders and focus on compliance. However, the issues and topics discussed are relevant to all boards. We urge all boards to set aside time to challenge how they are operating and to innovate including adjusting their processes, practices and procedures to improve board effectiveness.

Working with management

New Zealand's corporate governance framework under the Companies Act 1993 is based on a board of directors managing a company on behalf of its shareholders.

Usually, this involves the board delegating day-to-day management to professional managers while remaining responsible for monitoring and overseeing management. The board is also there to support and guide management and to work with them to achieve strategic objectives and sustainable success. We're hearing more about how boards and executive teams are working collaboratively, including upskilling in new areas.

It is sometimes said that directors 'work on the business, and not in it' and that they should have their 'noses in, and fingers out' of the business in performing their role. However, there will be times when non-executive directors will be more involved, especially in times of crisis or a major organisational event such as a takeover.

> "The days of strict allegiance to 'nose-in, fingers-out' seem to be waning. You may bring a special expertise to your board. But unless you're scanning the skies as well as the cafeteria, unless you have the courage to act with fingers in as well when required, your usefulness as a director will be hobbled and your company's future put at risk."

Rahul Bhardwaj, CEO of the Institute of Corporate Directors (Canada) at its 2019 conference.

The governance management divide

Accountability is central to corporate governance and the separation of governance and management provides clear lines of accountability. The board is accountable to the company and shareholders, and management is accountable to the board.

As the responsibilities, and liabilities, on directors continue to grow it is important that the roles do not get blurred. The importance of the separation between governance and management was highlighted by both APRA and the Hayne Royal Commission:

> "One of the challenges facing all boards is ensuring strong oversight of senior management while still preserving an appropriate separation from managerial responsibilities."[47]

> "Boards cannot, and must not, involve themselves in the day-to-day management of the corporation ... The task of the board is overall superintendence of the company, not its day-to-day management."[48]

A LEGAL LENS

Boards need to be sufficiently engaged with the business to adequately supervise management and meet the standard of care expected of them. The board's role is not to manage the business itself however. If it strays into doing so boards should be asking themselves if they have the right board and management in place.

INSIGHT INTO THE FUTURE

"We'll see more rather than less engaged boards – sensitivity to stepping over the governance line into management will dissipate over time under the weight of a more complex operating environment, greater stakeholder expectations and more accountability for performance. Directors will need to be more engaged in terms of knowledge of the entity's market, strategy, operations and how value can be created (or at least not lost). This will not be considered stepping into management. As a result directors will not be able to sustain a large number of roles, instead the reality of the workload for each role will drive fewer active roles and higher remuneration per role. The more hands-on approach will move boards away from selection of directors based on narrow skill sets to those who are able to make a broader contribution based on curiosity, adaptability and diligence. At that point the days of a governance career being a retirement option will be long gone, replaced by governance as more stage II of an active career."

Mark Cross, CMInstD

Technology and innovation in the boardroom

Technology has the potential to fundamentally change the way boards meet, breaking down global barriers for directors such as location and language.

It should also help transform the way boards operate to ensure directors are more informed and equipped to monitor and make decisions.

Boards can learn from recent TV series such as Netflix's BlackMirror and HBO's Westworld that highlight the dark side of technology including moral and ethical risks that are foreseeable in the not too distant future.

Will we need human directors or boards?

Disruption to boards and directors doesn't get any scarier than this existential question. AI and blockchain are two technologies that have the potential to disrupt not only how organisations are controlled and directed but whether there is a need for boards at all.

Robo directors

Many directors will have already heard about the world's first so called 'AI' or 'robo' director, referred to as VITAL (meaning Validating Investment Tool for Advancing Life Sciences). This is an algorithm (not formally appointed as a director) used by the board of a Hong Kong company for investment decisions. One *current* legal barrier in New Zealand to robo directors is that section 151 of the Companies Act 1993 requires directors to be 'natural persons'.

As technology advances, robo directors could be a real possibility. In 2015, a survey of 800 business leaders predicted AI would be on a board of directors by 2025.[49] There is a 50% chance AI will exceed the general intelligence of a human by 2040 and a 90% chance by 2065, according to the median estimate of respondents in a survey of experts.[50] In the short term, we don't see robo directors replacing humans in the boardroom. Rather, AI will assume a greater role in augmenting board decision-making.

Blockchain governance and distributed organisations

Another potential disruptor to boards and directors are blockchain based 'distributed organisations'.[51] These organisations, sometimes referred to as DAOs (decentralised autonomous organisations), follow computer code and are controlled by shareholders without the need for boards. The technology is relatively new and it has the potential to be used across society, not just for business. Time will tell if it can be scaled up to apply to large and complex organisations.

What is blockchain?

"At its core, blockchain is a record keeping system. It's like a decentralised database, or ledger, that is shared and maintained on multiple computers. When a user makes a change, all copies of the database are updated and reconciled almost simultaneously. No one can change the data in a blockchain without other people seeing."[52]

TIME TO ASK

How could AI help the board to recruit, vet and appoint the CEO? What are the ethical issues and risks?

The digital boardroom

Most leading directors and boards already use board management software such as Diligent to support their governance functions. There are significant benefits to this technology for directors including instantaneous access to board information from anywhere in the world. Utilising this technology is only the beginning of the journey towards a fully digital and integrated boardroom.

Leveraging the power of data

A more significant transition for boards will be moving away from reliance on traditional, static tools that capture data and insights at a point in time such as Excel and PowerPoint. With advances in cloud technologies, AI and data analytics, directors in the future will access and use real time, interactive data and analysis in, and out, of the boardroom. This will help lead to more informed decision making and will enable boards to better monitor organisations from a compliance and risk perspective. It should also create efficiencies such as generating more time for directors to spend on strategy and performance. An example of this new way of operating is the SAP Digital Boardroom, a cloud based system which provides real time access to data and business insights enabling boards and management to reinvent meetings.[53]

As part of the future digital boardroom, boards will need to continue to leverage big data and open data (data that can be accessed, used and shared by anyone), and other new technologies such as smart contracts.

VR in the boardroom

Virtual reality (VR) technology has existed for some time and is now being used in boardrooms. It has significant potential to help address some of the challenges of board effectiveness. VR may be especially helpful for organisations with large-scale operations and global directors.

Virtual site visits

VR also provides a greater opportunity to experience the business in different ways such as showing directors remote locations or new premises that are under construction. We don't see VR replacing site visits but it will be a valuable supplemental tool. VR will also enable directors to appreciate health and safety risks in the business in new ways, for example by getting to experience what it is like for staff using certain machinery.

Beaming in to board meetings

Attending a meeting by phone or via video is no substitute for being there in person as much communication is non-verbal. This can impact board dynamics. What difference would it make if directors could experience all meetings as if they were there in person, for example by attending virtually by VR or holoportation technology? A number of companies, including Microsoft, are working on revolutionary holoportation technology. Add to this advancements in real-time language translation and this may help overcome some barriers for global directors.

TIME TO ASK

How can technology enable your board to transform how it is operating?

INSIGHT INTO THE FUTURE

"The future board will unquestionably have access to more real-time data and analysis because this is already starting now. Boards need to use this in the right way in terms of their governance role, rather than getting into management. That is the difficult part and it will take work. It is critical that boards stay focused on the future and digital and technology advances will also help with this, especially forecasting and predictive tools."

Joanna Perry, CFInstD

Reporting revolution

In 1903, US Steel published what is known as one of the earliest corporate annual reports with its financial accuracy certified by Price, Waterhouse & Co.[54]

Despite major change in how we create and consume information, not a great deal has changed in corporate reporting in over a century. Companies still produce annual reports with auditors providing assurance over (primarily) financial information covering the previous year. However, there have been major changes in corporate value, for example with the rise of intangible assets. It is often said that up to 80 percent of company value is made up of intangible assets such as brand, data, IP and organisational/social capital, but they are still massively under-represented on the balance sheet.[55]

TIME TO ASK

Does the annual report still serve its purpose? Are accounting and auditing standards enablers or impediments to building greater confidence and trust with stakeholders?

INSIGHT INTO THE FUTURE

"There will be more real time communication and access between directors and stakeholders. This will be both online and direct, in print, audio and video. Annual reports as such will be less dominant, though still a vital record of what has occurred and for measuring performance. The annual meeting may not be as important and could even disappear."

Rob Campbell, CFInstD

With high-speed data and the rise of technologies such as blockchain and AI there is huge potential for disruption and transformative change in how companies report, verify and communicate performance information. In a 2019 report the United Kingdom's Financial Reporting Lab examines the use of AI in the production, distribution and consumption of corporate reporting and concludes that "it is not a question of will AI become important for corporate reporting, but when?"[56]

The Lab assesses how AI can be used in the finance and reporting processes, including automating elements of preparing the annual report. It also considers there is future potential for "the annual reporting-cycle to end, with reports being generated at any point of time and covering any time period."[57] This may be 10 – 20 years away but in the meantime AI is expected to improve efficiencies in annual report preparation through digitising and automating various finance and reporting functions.

Evolving corporate disclosure

The rise in voluntary disclosure, for example through reporting frameworks such as Integrated Reporting and sustainability reporting illustrates the trend for more open corporate communication that goes beyond compliance. Social and environmental issues will continue to be on company agendas and consequently will be in their disclosures in the future.

Activist shareholders, and stakeholders, will continue to expect greater transparency and the opportunities will only increase for organisations to use technology to engage in genuine two-way dialogue.

In a significant change in the new *NZX Listing Rules*, continuous disclosure is required not only where directors or a senior manager comes into possession of material information, but also when they ought to be aware of that information. We expect that boards and management will adjust their processes as a result of this change and greater attention will be given to this in the future.

See also *What directors need to know about the new NZX Listing Rules* by MinterEllisonRuddWatts and the IoD.

The advent of social media and other communication platforms have changed the continuous disclosure landscape bringing new risks, highlighted by Elon Musk's tweets last year about potentially taking Tesla private. Boards will need to be alert to new risks in this space in the future.

A LEGAL LENS

With a constructive knowledge test now applying to their continuous disclosure obligation, listed companies must have adequate processes and arrangements in place to enable material information to be promptly identified and appropriately escalated to allow directors to comply with their duties.

INSIGHT INTO THE FUTURE

"I expect future boards will be gaining assurance in many different ways, for example companies that use blockchain or AI will rely more on technology based assurance alongside human judgment and intervention. Auditors will still play an important role but they will engage with boards in a more dynamic way providing greater real time assurance. Boards will also gain assurance by using technology and external data sources to test and validate information reported by management. As recognising social licence to operate becomes more paramount audit will be as focused on non-financial as financial matters."

Julia Hoare, CMInstD

Dynamic assurance – auditing in real time?

Boards will always need to have confidence and trust in the information they use for decision-making and reporting externally. But how they get there will change as new technologies and capabilities disrupt how boards gain assurance, internal and external, over corporate information.

Technology is changing how organisations operate (eg with blockchain smart contracts and advanced algorithms and machine learning to predict inventory levels and manage cash flow) and this means that monitoring and oversight functions will need to adapt. Boards need to harness technologies to ensure effective risk assessment and that controls and processes are functioning effectively.

Boards, audit committees, internal and external auditors will increasingly be able to access external sources of data to test and validate internal information. For example, "a board wanting to challenge culture or customer disclosure could use AI tools to source and analyse external opinion such as Glassdoor™ or Twitter™."[58]

The speed of creating and making data available will also drive more dynamic or instant auditing. We expect there will be more sophisticated data analysis, enhanced transparency over audit processes and greater insight into companies' systems and control environment. It could also mean continuous assurance through real-time auditing.

KPMG's Clara is a smart audit platform using new technologies, and powerful data and analytics capabilities.

This video[59] by KPMG (UK) provides a peek into *Audit 2023: Audit technology fit for the future* and what real time audit supported by smart technology could look like in detecting a fraud as it is occurring.

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