
Corporate Governance in the Boardroom

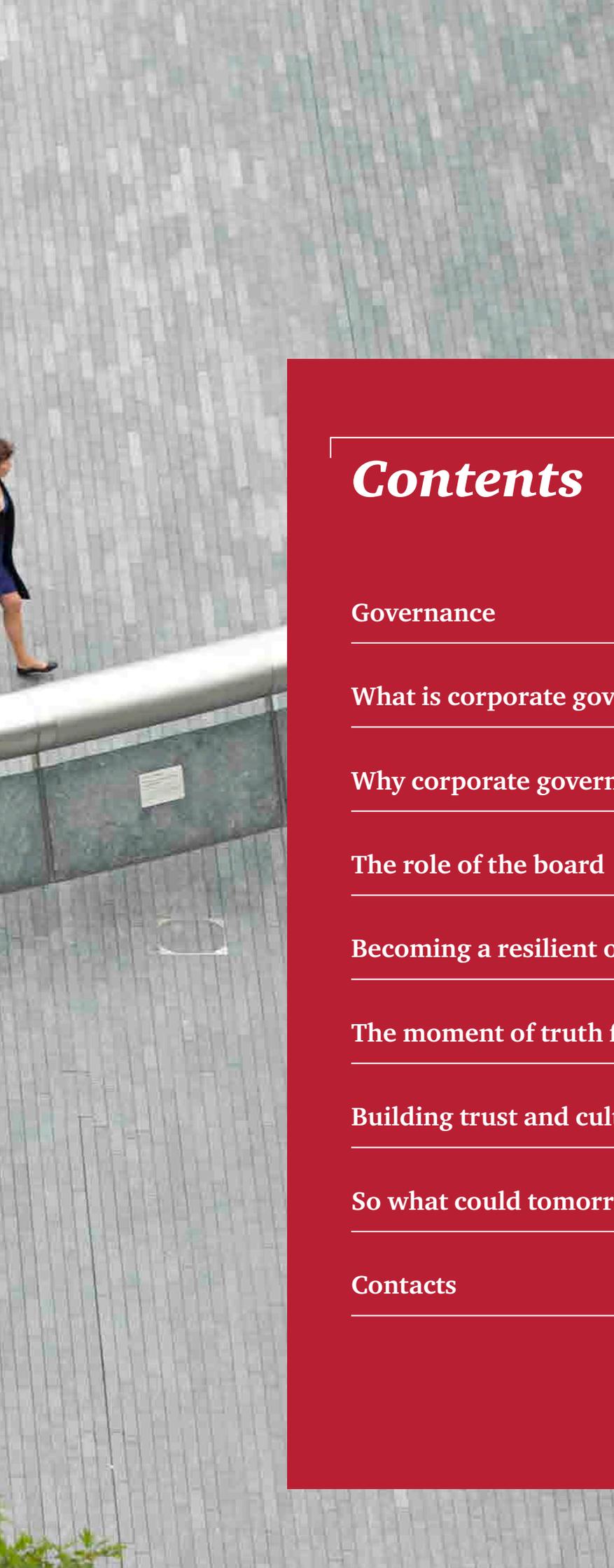
A practical perspective

A PwC Point-of-View Paper

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Governance

The bedrock of any successful business

In an era when trust in business is at a premium, and scrutiny from stakeholders is ever wider and more intense, it has never been more important for organisations to behave in accordance with their core purpose and principles in order to protect reputation and trust. Corporate governance is a vital mechanism through which boards can ensure that the behaviours of their workforce are aligned to the organisation's purpose and principles – and that corporate goals and values are translated into their people's decisions and actions.

Our latest thinking is that good corporate governance can be summarised under three main themes.

First, effective corporate governance is grounded in a clear view of what matters most to the business, the full range of risks facing the organisation, and how these risks relate to the business and its strategic priorities. Only with an understanding of these areas is it possible to say what is or isn't a risk. Second, it begins and ends with the board, which is responsible for crystallising a clear corporate purpose, exhibiting the right values, and ensuring these are being acted upon. Third, behaviour and decisions in the 'moments that matter' represent the ultimate test of good corporate governance – not least when a crisis hits.

When boards succeed in creating and sustaining effective corporate governance, it generates a range of business benefits that combine to create higher trust, stronger resilience and enhanced competitive edge. So this is not just an ethical responsibility for the board, but a strongly commercial one as well.

Our long-standing view on risk awareness as the bedrock of good corporate governance is echoed in the Financial Reporting Council (FRC)'s latest revisions to the UK Corporate Governance Code, which emphasise the importance of risk appetite and risk culture. We welcome this step forward. And we believe it represents a further reinforcement of the importance of risk leadership – heralding a future in which more companies appoint a specific executive to scan the entire horizon of risks across and beyond the organisation on behalf of the board.

At root, the best corporate governance creates a clear and visible line of cause-and-effect from the board's mandate, purpose and values all the way to the cultural norms and everyday behaviours exhibited at all levels. A business that can demonstrate this linkage will be well placed to outperform its competitors and provide a step further to achieving their goals. PwC urges all boards to take this message to heart. Resilience will be built into the organisation to the ultimate benefit of the stakeholders.

Drawing on our seminar series for non-executive directors

Over the past three years, PwC has run a succession of seminars for non-executive directors focused on governance and risk. This paper summarises some of the themes covered in these seminars, and encourages boards to ensure that their governance, especially when looked at through the lens of reputation and resilience, has adapted – and continues to adapt – to the high-pressure environment in which they operate.

What is corporate governance?



Corporate governance is one of the most frequently used – some might claim overused – phrases in the business lexicon. But different people often have different perspectives on what it actually means.

For some, corporate governance is primarily about legal structures. For others, it's mainly about business controls, and the check and balances on how people carry out their work. For a third group, it's a much wider concept encompassing the entire way a business is led and managed.

Crucially, risk occupies a position at the heart of the five pillars, and is the unifying element linking them all.

The five pillars of corporate governance

Our view is that effective governance is founded on five pillars, all of which are interrelated, and each of which must be in place and functioning well for governance to do its job (see Figure 1). The pillars are:

Figure 1: The five pillars of effective corporate governance

| Key framework elements | Leadership strategy and culture | Structure and performance oversight | Risk | Management information and controls | Transparency and reporting |
|--------------------------|--|---|---|---|---|
| Code 'Principles' | Leadership | Effectiveness | Accountability | Remuneration | Relations with shareholders |
| Framework sub-components | <ul style="list-style-type: none"> • Tone at the top • Conduct • Chairman & CEO • Decision making • Strategy setting • Reserved matters and delegations • Board meetings • Relationships with management | <ul style="list-style-type: none"> • Board composition and commitment • Appointment succession and re-election • Board committees • Board evaluation • Induction and training • Management information and advice • Entity governance • Auditor relationships | <ul style="list-style-type: none"> • Risk appetite • Risk and control culture • Principal risks and going concern • Risk management framework • Risk and control monitoring • Policy framework • Assessment of effectiveness | <ul style="list-style-type: none"> • Execute compensation and benefits • Performance related remuneration • Incentive schemes (Share schemes/pension) • Remuneration balance • Risk adjusted reward • Balanced scorecard • Non-financial performance | <ul style="list-style-type: none"> • Stakeholder engagement • Stewardship Code • Annual General Meeting (AGM) • Financial and non-financial reporting • Regulator(s) |

Leadership strategy and culture

The way a business's leaders conduct themselves and communicate on a daily basis – and the ethics and values they exhibit in doing so – are instrumental in setting the 'tone from the top'. This tone shapes every action, decision and relationship across the organisation. As a result, the right leadership tone is the starting-point and bedrock not just for corporate governance, but also for the effective overall management of any business.

1



Structure and performance oversight

The tone from the top must be infused and embedded at all levels of the organisation, through structures that ensure it is translated into everyday behaviours. Mechanisms for achieving this include monitoring by the board and its various sub-committees, assurance through functions such as Internal Audit and Compliance, and contingency plans for crisis management.

2



Risk

Risk is the pillar which lies at the heart of corporate governance, underpinning and interconnecting the other four. All components of an organisation's governance framework need to be designed and managed in the context of its overall risk appetite, reflecting the fact that managing risk – and being accountable for doing this effectively – are central to the board's role. The right focus on identifying and owning risk equips the board to understand, analyse, prioritise and manage risks of all types, supported by the Risk & Compliance Officer.

3



Much has been written about the changing risk landscape – with contributions ranging from PwC's own thought leadership on the global megatrends, to the World Economic Forum's annual Global Risks report, to the UK Institute of Directors' 'Responding to Global Risks' publication (see information panel). Whatever shifts occur in the risk landscape, an approach based around the five pillars of our corporate governance framework – with risk awareness at its core – will both ensure appropriate focus on risk by the board, and also enable an organisation to reflect the increased focus on risk appetite and risk culture promoted by the FRC in its recent revisions to the UK Corporate Governance Code (see information panel).

Management information and controls

Clear and open reporting requires a solid underpinning of timely and accurate management information, so both financial and non-financial impacts and performance across the business can be monitored, measured and benchmarked against relevant key performance indicators (KPIs) using a balanced scorecard approach. This pillar encompasses the information systems for collecting, analysing and reporting the information, and reward and recognition processes that encourage the behaviours that the board wants to see across the business.

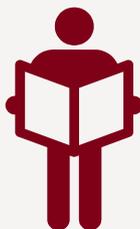
4



Transparency and reporting

One of the benefits of a well-developed structure and effectiveness is that they enable the business to communicate in an open, accurate and timely way with all its stakeholders. This means interested parties ranging from shareholders to regulators, from employees to environmental NGOs can gain a clear understanding of the business's unifying purpose or 'board mandate', how its chosen strategy aligns with this purpose, and how it's pursuing this strategy.

5



'Responding to Global Risks: A practical guide for business leaders, 2014' – The Institute of Directors (IoD)

This publication – with contributions from the IoD itself, PwC, Airmic, Marsh and Zurich – builds on the World Economic Forum's 'Global Risks' report, to examine how organisations, boards and individual leaders can better understand the impacts of global risks, and build resilience to them at both a strategic and operational level. As the IoD highlights in the foreword to its report: 'This is by no means negative thinking. Improved resilience breeds increased confidence, greater enterprise and other benefits. Equally positive is the reality that a threat to one organisation can be an opportunity for another... Businesses can achieve competitive advantage through an effective response to global risks.'

The FRC Corporate Governance Code: raising the bar for risk management – the role of the Board

In September 2014, the Financial Reporting Council (FRC) issued an updated version of the UK Corporate Governance Code for UK-listed companies. Announcing the new Code, the FRC said it aimed to significantly improve the quality of information investors receive about companies' long-term health and strategy, and to raise the bar for risk management.

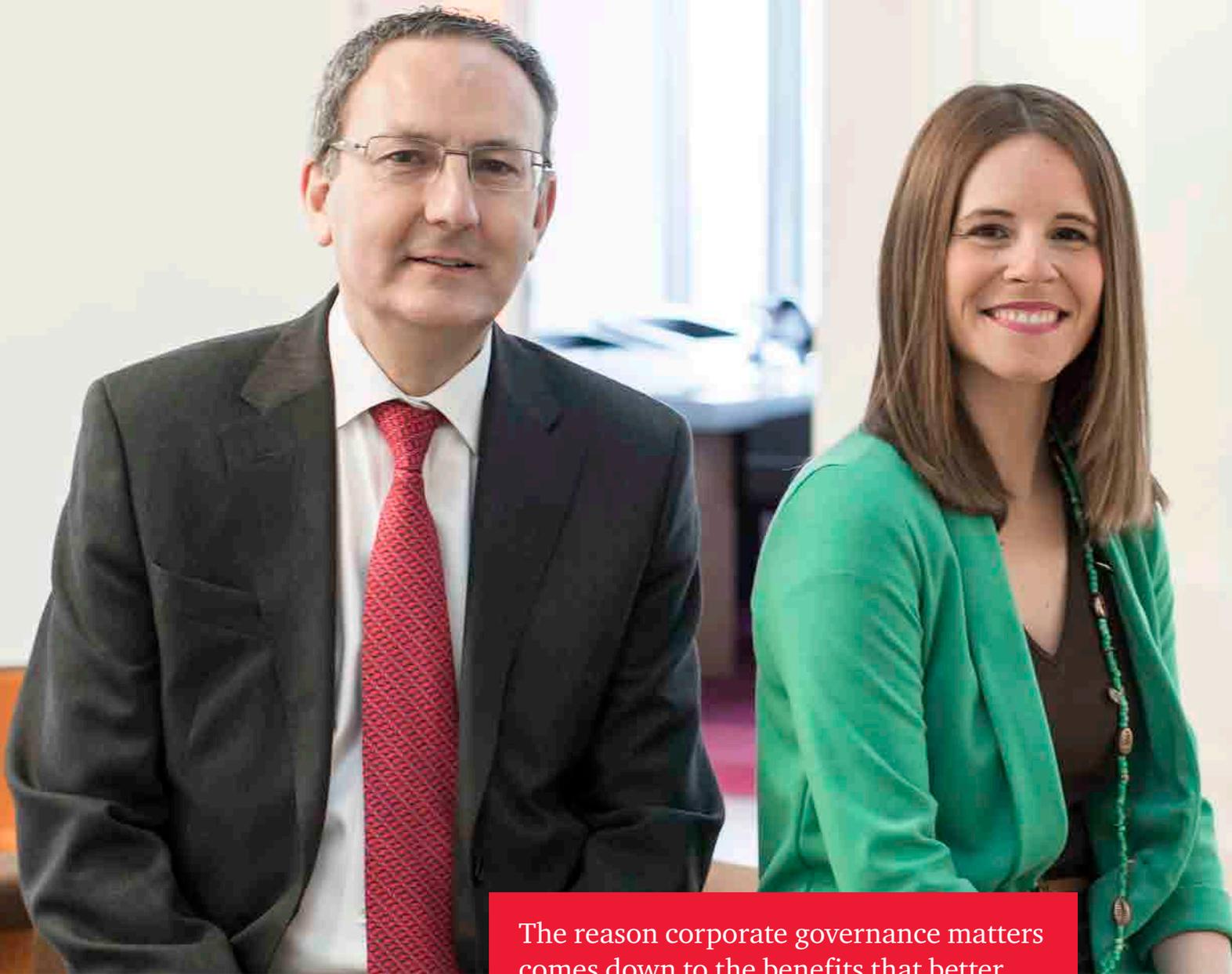
The FRC also highlighted the importance of the board's role in establishing the company's 'tone from the top' in terms of its culture and values. It stressed that the directors should lead by example, in order to encourage good behaviours throughout the organisation.

¹ Source: 'Five Megatrends and possible implications', PwC, April 2014: http://www.pwc.com/en_US/us/corporate-governance/publications/assets/pwc-corporate-governance-directors-megatrends.pdf

² Source: 'Global Risks 2015', World Economic Forum, : <http://www.weforum.org/reports/global-risks-report-2015>

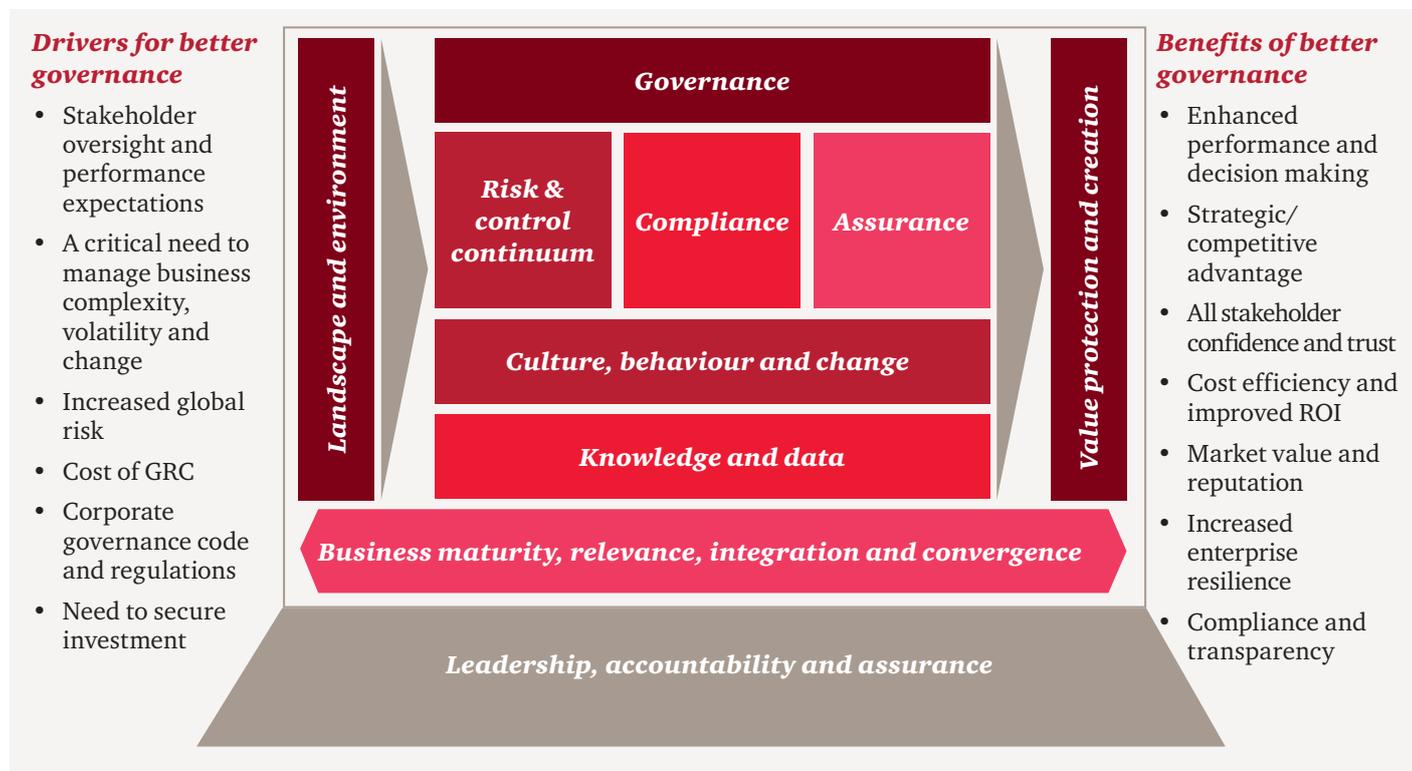
³ Source: 'Responding to Global Risks: A practical guide for business leaders, 2014.': <http://www.director.co.uk/Content/PDFs/Responding-to-global-risks-web-edition.pdf>

Why corporate governance matters



The reason corporate governance matters comes down to the benefits that better governance delivers, as illustrated in Figure 2.

Figure 2: The context for corporate governance – drivers and benefits



As the chart shows, there are several drivers for better governance. These range from stakeholder performance expectations to the need to manage increased complexity and risk, and from various regulatory requirements to the desire to secure capital at an affordable cost. But what’s interesting is that not all drivers are of equal importance in achieving effective corporate governance.

These diverse drivers feed into – and help to shape – the business’s corporate governance structures, processes and cultures as applied and maintained by the board. Many boards have historically focused on legal structures and internal business controls as the core of their corporate governance. However, as the FRC has highlighted, elements such as management of external risks, setting the right ‘tone from the top’, and embedding a culture of ethical values and behaviour are equally as important – if not more so – in governing today’s businesses.

And, in our opinion the most effective drivers are those that focus on the desire ‘to do the right thing’ rather than those that are forced on an organisation as a result of regulation.

The benefits of better governance reinforce this, and underline the business case for investing in effective governance. They include strategic advantage, greater resilience both to sudden shocks and long-term change, and higher confidence among all stakeholders in the business’s ability to generate value in the future. Ultimately, all these benefits come together in a single, invaluable asset: higher trust. An organisation that is demonstrably and visibly well-governed will generate stronger trust both internally and externally – and will enjoy an inherent competitive advantage over its less trusted counterparts, in the ongoing battle for better relationships, revenues, talent and investment.



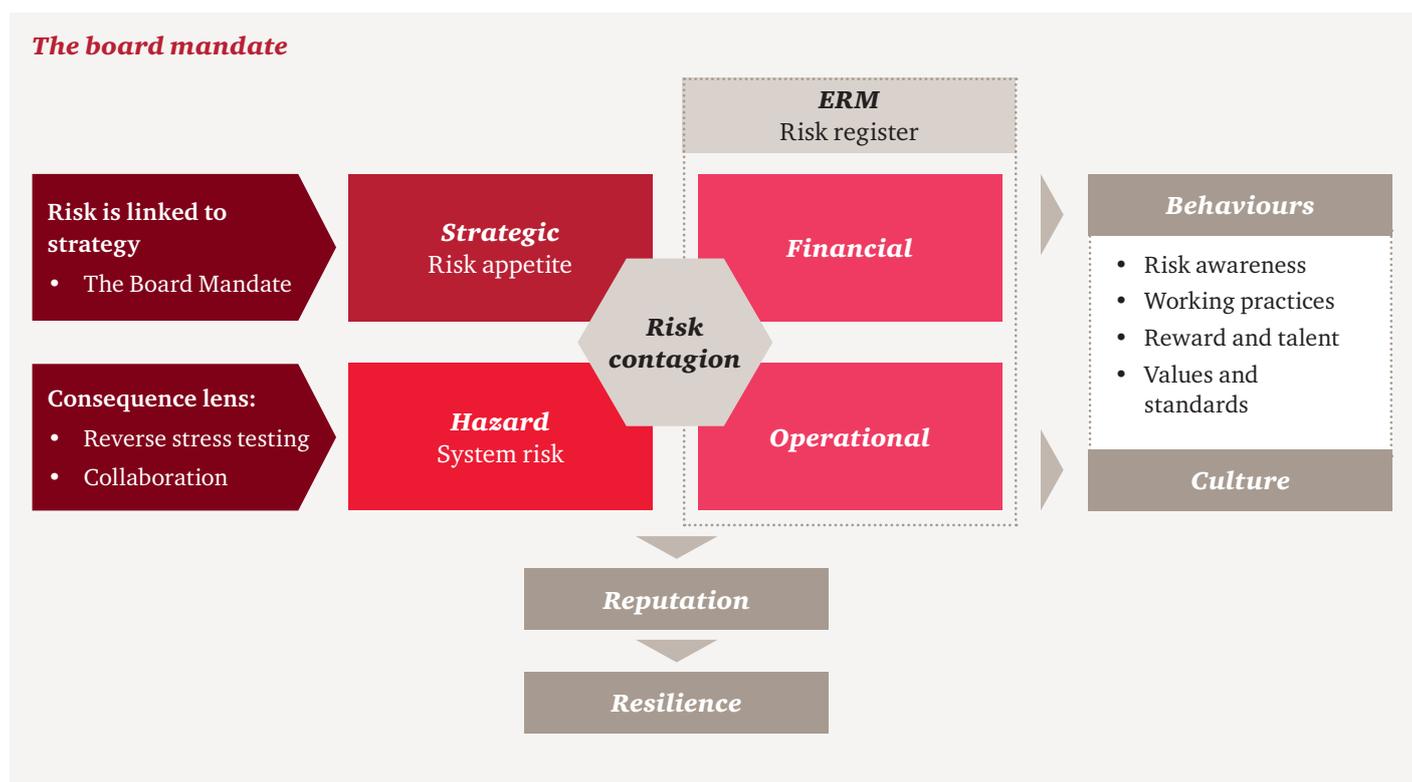
The role of the board

From setting the right ‘tone from the top’ to maintaining and monitoring business controls – and from rewarding the right behaviours to communicating openly and transparently with all stakeholders – the board plays a pivotal role in all aspects of corporate governance. These activities can sometimes be disconnected, so it’s the board’s role to apply the right risk lens to every decision and action. For this to be a success, organisations need to have the right people on the board – challenging, experienced, inquisitive and with the time to understand both the risk landscape and their legal and ethical responsibilities.

Adapting to the four types of risk in today's risk landscape

The board is best placed to enable and ensure effective corporate governance. As Figure 3 shows, today's risk landscape includes four broad categories of risk that the board must monitor, manage and mitigate: financial, operational, hazard, and strategic risks.

Figure 3: The role of the Board – from mandate, via risk lens, to culture & behaviours



1. Financial risks are usually a regular focus of board risk discussions, with strong impetus coming from today's increased regulatory, accounting and financial audit focus. Financial information is clearly a key element of stakeholder communications, performance measurement and strategic delivery.

2. Operational risks are typically managed from within the business, and often focus on market, quality, compliance and health and safety issues where industry regulations and standards require. These risks may affect an organisation's ability to deliver on its strategic objectives.

3. Hazard risks tend to stem from major factors that affect the environment in which the organisation operates. While contingency planning is often used to help address them, there is a danger that the difficulty of controlling these risks means boards may not take them into account when formulating strategy.

4. Strategic risks arise when the strategy gets out of line with what the business needs to do to create value sustainably, typically because of external change. In cases where a board get too 'bought in' to a particular strategy, these risks may be missed out from its risk register.



The starting-point: the board mandate...

So, how can a board ensure its risk lens captures all types of risk, and thereby contributes to robust and holistic corporate governance? PwC's view is that the journey to more comprehensive and joined-up governance begins from the business's overarching purpose or 'board mandate' – a term defined in the accompanying information panel drawn from Tomorrow's Company. As this definition makes clear, the mandate encapsulates what the company stands for, and what it wants to be known for, across everything it says and does and in all its relationships.

With this in mind, a board looking to enhance the quality and scope of its corporate governance should first step back and agree a clear and explicit purpose and *raison d'être* for the organisation as a whole. It should then use this purpose as the starting-point for its risk discussions. Finally it needs to ensure that it has the right balance of people and skill sets around the boardroom table.

To appreciate how vital this is, consider the impact on a business if its Board lacks a clear and agreed idea of its mandate. Without an understanding of the organisation's overall purpose, the directors will inevitably struggle to create the right strategic plan and the appropriate risk appetite to support its execution. They will also find it hard to build trust both internally and externally, since stakeholders within and beyond the business will be unclear what it is really trying to achieve, and how.

It follows that strategy, risk and the board mandate are all integrally linked – and impacts in the strategic risk category can be felt across all types of risk through rapid contagion. Imagine a situation in which the emergence of previously unforeseen risks around the strategy of an industrial company cause key component suppliers to demand payment up front, simultaneously triggering financial and operational risks as well.

Tomorrow's Company: defining the 'board mandate'

'A mandate captures the 'essence' of the 'character' and distinctiveness of the company, in terms of: its essential purpose; its aspirations; the values by which it intends to operate; its attitude to integrity, risk, safety and the environment; its culture; its value proposition to investors; and plans for development. It is a living statement about what the company stands for and how it wishes to be known to all of its stakeholders.'

Source: Tomorrow's Company: **'Tomorrow's Corporate Governance: The case for the 'Board Mandate'**



...and controlling the risk levers

Given the potential for this type of contagion, it's crucial that the Board does everything in its power to address all four types of risk, in line with its agreed board mandate and risk appetite. In general day-to-day, financial and operational risks are controlled through the established structures including Enterprise Risk Management (ERM) processes, risk register, Audit and Risk Committees, and so on.

However, a factor to bear in mind is that risk registers created under ERM approaches have traditionally focused primarily on financial and operational risks, and less on strategic and hazard risks. There has been a tendency for risks to be evaluated on a 'bottom up' basis rather than focusing on major risks affecting the achievement of strategy. This consequently creates the danger of a 'blind spot' around these potentially catastrophic risk types. Another factor is that, especially with today's constant global scrutiny via social media, risk contagion between the various categories can occur at breath-taking speed. For example, a strategic or operational risk event may create an immediate financial risk by undermining confidence among major customers and/or providers of capital. So some risks may cross into or out of the boundaries of ERM.

We're not suggesting that ERM approaches are misguided – but rather that today's more dynamic and interconnected risk landscape means ERM alone is not enough. With its financial and operational risks 'nailed down' using ERM, the board can maintain a wider view of evolving strategic risks through techniques such as ongoing horizon scanning and orthodox scenario planning: 'What if 30% of our customers switch to digital alternatives? How about if our two biggest competitors merge?'

Preparing for the consequences of unforeseen risk...

But however well prepared a business may be, things can still go wrong. Hazard – systemic risk – is ever-present. By its nature, hazard is unforeseen, unpredictable and emerges from left field. So, in an increasingly uncertain and interconnected world, how can companies prepare for the impacts of unforeseeable risk events?

The answer is to apply a ‘consequence lens’, by identifying the potential outcomes of an as-yet unknown event, without getting distracted by all the possible causes, and then creating contingency plans to deal with those outcomes if they arise. This approach, often termed ‘reverse stress-testing’, was described in a 2012 PwC paper entitled ‘Black swans turn grey: The transformation of risk’ (see information panel).

By way of example, take the impacts on businesses of an epidemic such as Ebola, Swine Flu or SARS – the consequences of which can be access to specific markets, and possibly the loss of many staff. Similar consequences could result from other scenarios where staff and mobility are lost for a period, such as

strikes, terrorist action or major transport disruption due to extreme weather. Organisations can plan and test their own readiness to deal with such consequences without needing to identify the specific scenario that’s created them.

In other words, a lack of clarity over the cause does not prevent a business preparing for the outcome. So boards should take pains to pinpoint the critical events and exposure points that could effectively bring the business to a standstill, and work out how they will navigate through disruptions in these areas.

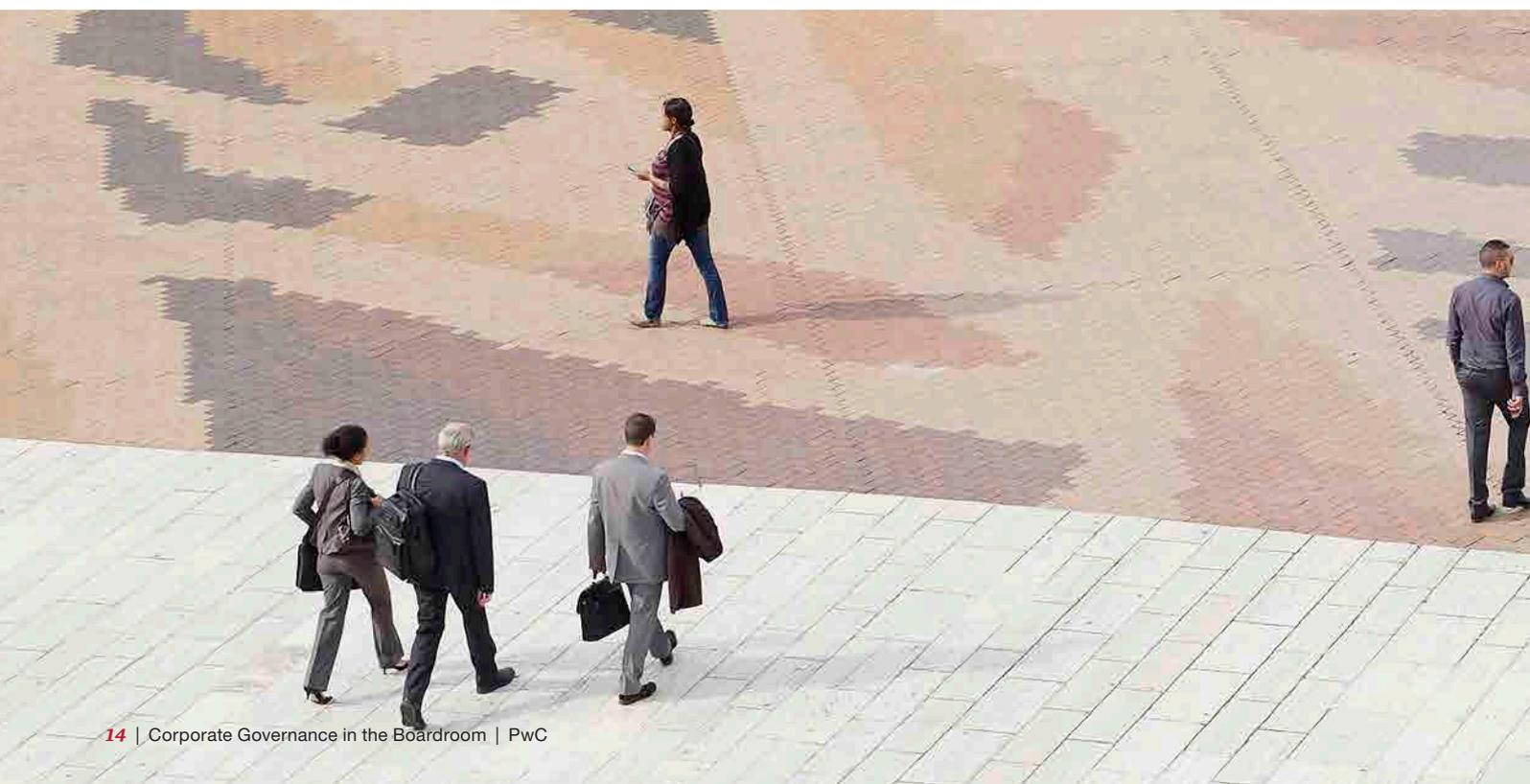
While such exposures to hazard vary between industries, every sector has them: think how the tragic earthquake and tsunami in Japan in 2011 triggered a collapse in supplies of key components to automotive companies worldwide. Irrespective of the root cause, what mattered at that moment was the plans and alternative sourcing arrangements that carmakers had in place to ride out this type of supply chain disruption.

Reverse stress-testing: preparing for consequences – not predicting causes

‘With the growing uncertainty in the risk landscape, a technique that is being used increasingly in both the public and private sectors is ‘reverse stress-testing’. This approach effectively accepts that it is no longer possible to forecast events themselves, and instead focuses on managing their knock-on effects or consequences.

‘To pick recent examples, an airline might test out the impact of most of Europe’s airspace being closed down (as occurred with the volcanic eruption in Iceland), or a bank might model the effect of a major counterparty collapsing (Lehman Brothers) or a Euro member country defaulting. Reverse stress-testing is proving to be a very effective way of focusing on extreme events and protecting organisations against ‘unknown’ risks.’

Source: ‘**Black swans turn grey: The transformation of risk**’, PwC, 2012



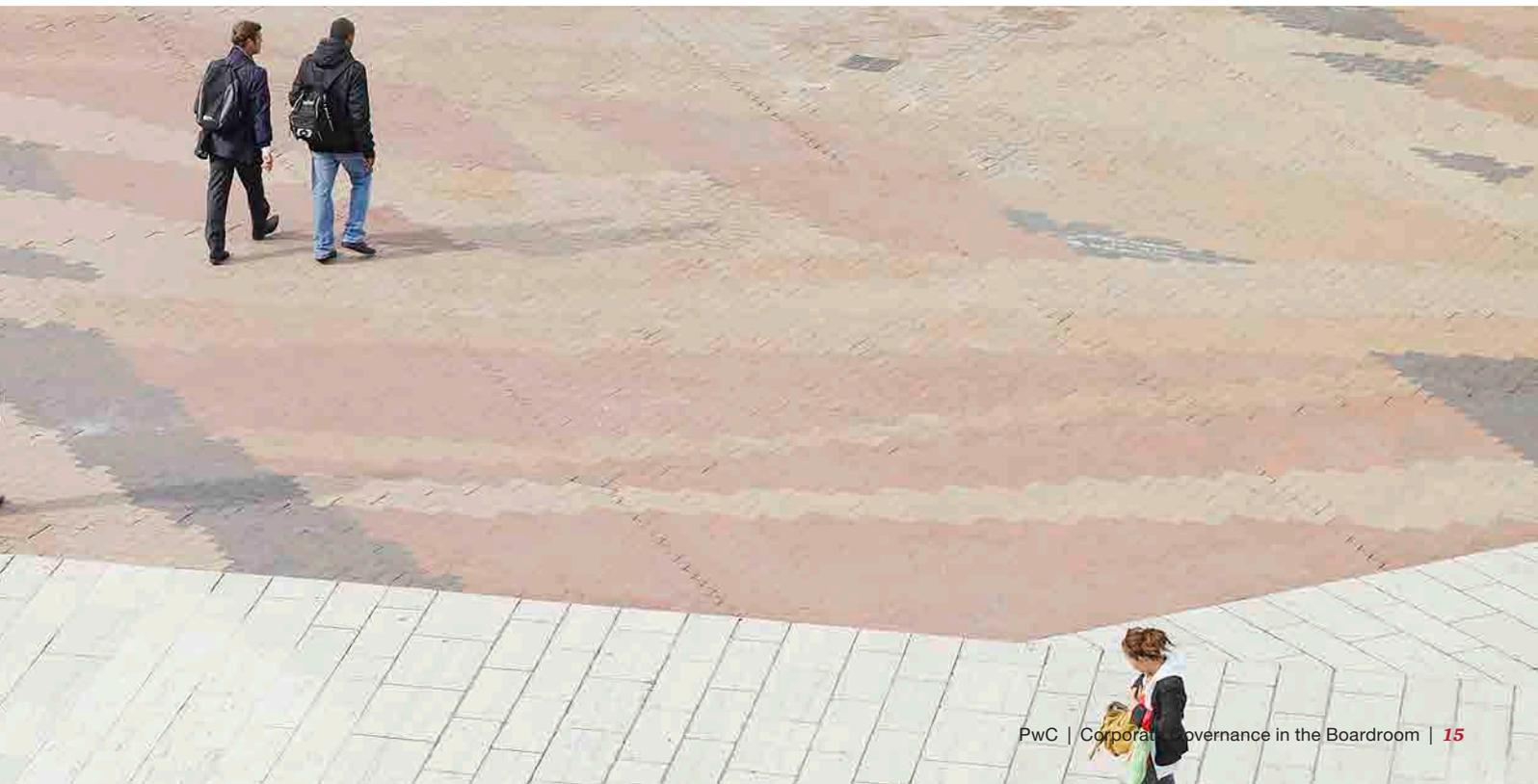
...while keeping a close eye on behaviours

While it is vital for boards to establish as much visibility and control as possible over each of the four key types of risk – financial, operational, strategic and hazard – its role does not end there. The single biggest risk to any organisation – overarching and impacting all the others – is the embedded culture and behaviours of its workforce.

As we highlighted earlier, it is crucial that the board sets the right tone from the top, aligned with the board mandate, through its ethics, values and behaviours. But this tone will come to nothing if it is not reflected at the bottom of the organisation and every level in between.

Appreciating the culture of the organisation and indeed the differing cultures within different parts of the business is critical. For example a ‘good news’ culture may be a warning sign that problems will be hidden, whereas a business that embraces bad news and deals with it effectively provides confidence to the board.

This imperative raises many questions. Are our people risk-aware? Do they feel able to raise concerns and whistle-blow if necessary? Are working practices aligned with our values and standards? Do our rewards and management structures encourage the right behaviour and visibly penalise wrongdoing? If at any point our culture and behaviours deviate from our values, are we equipped to find out why and ensure it doesn’t happen again?



Becoming a resilient organisation



Becoming a resilient organisation

If you're getting these components right, then you're on the journey towards being a 'resilient' organisation. But staying on track requires a clear understanding of what is meant by resilience, what it looks like, what levers contribute to it, and what benefits it generates. All of this is both desirable and achievable: in PwC's view, organisational resilience is now the most important discipline in business, and is becoming better understood to a point where it can be measured – and managed.

The first step is to accept the difference between risk management and resilience. Our use of the term

'organisational resilience' embraces the definition that's now guiding the bodies – including the BSI and the ISO – whom PwC thought leaders have been helping develop standards for: 'Resilience is an organisation's capacity to anticipate and react to change, not only to survive, but also to evolve.'

The key word is 'change'. To be resilient, it's true that you need to be able to manage through an earthquake's disruption of a supplier factory. But you also need to manage through long-term shifts in consumer purchasing behaviour. So resilience isn't just about surviving shocks: it's also about bouncing back from profound changes

and transforming to be stronger than before. This dual nature of surviving and bouncing back has been investigated in a previous PwC paper, 'Prospering in an era of uncertainty: The case for resilience'.

It's clear that change in today's business environment is faster and more profound than ever before – thus reinforcing the need for resilience. But resilience to change has always been vital. What's different today is the necessity to take greater risk in a rapidly-changing and unpredictable environment – and to pinpoint and act on emerging opportunities at pace, before competitors do so.

Isolating underlying risk factors...

Roads to Ruin is a research study produced by Cass Business School on behalf of the Association of Insurance and Risk Managers (Airmic) examining a decade's worth of major corporate crises (see information panel).

The researchers' analysis revealed a set of six common factors in the behaviour exhibited by the boards of the crisis-hit companies:

- Boards fail to identify and guard against threats to the organisation's reputation and licence to operate.
- Boards fail to question the foundations of success.
- Boards are influenced by a dominant CEO.
- Boards fail to set and control risk appetite.
- Boards fail to recognise a change in the risk environment.
- Boards do not plan for a crisis.

... and then advancing the focus to resilience

Airmic built on the insights in Roads to Ruin by commissioning Cranfield School of Management to research a further valuable report, Roads to Resilience: Building dynamic approaches to risk to achieve future success. Sponsored and supported by PwC, this study involved interviews with executives, management and staff with risk management responsibilities, including CEOs, at eight selected organisations.

The researchers on Roads to Resilience found overwhelmingly that the key to achieving resilience is to focus on ensuring the right behaviour and culture – a step that may involve fundamentally re-thinking and challenging prevailing attitudes towards risk. They added that traditional risk management techniques – while making an essential contribution – do not in themselves create a culture of resilience.

The study concluded that resilient companies generally:

- Have exceptional risk radar.
- Build effective internal and external networks.
- Review and adapt based on excellent communications.
- Have the ability to respond rapidly and flexibly.
- Have diversified resources.

'Roads to Ruin': the perils of unrecognised and unmanaged risks

Airmic commissioned Cass Business School to analyse 18 high-profile corporate crises that had occurred during the previous decade. Seven of these had resulted in the company involved facing bankruptcy, with three eventually being 'rescued' by government. In 11 of these crises the Chairman and/or CEO lost their jobs, and in four cases executives received prison sentences. All of the companies were damaged.

The report found that these crises all involved deep-seated – and often unforeseen – 'underlying risks', which were dangerous in four ways:

- Many posed a potentially lethal threat to the continued existence.
- When they materialised, the risks often caused serious, sometimes devastating and almost always uninsurable losses to the business, its reputation and its owners, while also putting the positions of the CEO and/or Chairman under threat.
- Many of these risk events helped to transform serious – but potentially manageable – crises into catastrophes that destroyed reputations and licences to operate.
- Most of these risks are both beyond the reach of current risk analysis techniques, and also beyond the remit and expertise of typical risk managers. Unidentified and therefore unmanaged, these risks remain unnecessarily dangerous.

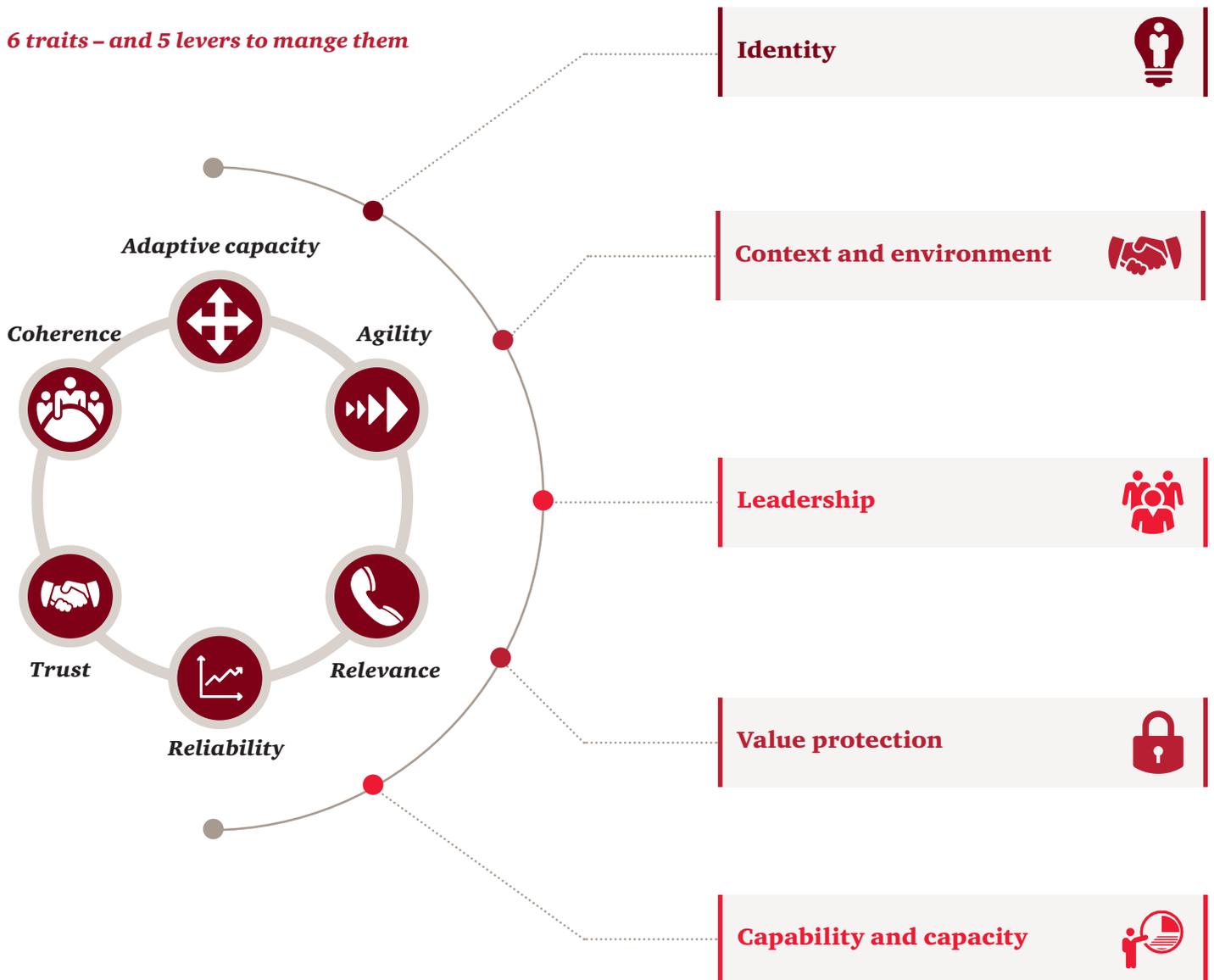
Understanding what resilience looks and feels like

So, what does a resilient organisation look like? PwC's answer is summarised in the Enterprise Resilience Framework in Figure 4. In our view, organisations demonstrate resilience by exhibiting six traits. Three of these – coherence in

decision-making, adaptive capacity, and agility – reflect primarily internal capabilities. These traits are clearly vital in responding to a crisis, but they're also hallmarks of a company that can exploit change.

Figure 4: PwC's Enterprise Resilience Framework

6 traits – and 5 levers to manage them



The three remaining traits – relevance, reliability, and trust – reflect the organisation's external relationships with customers, business partners and other stakeholders. These may sound like soft traits, but quite the reverse is true.

For example, relevance is particularly important when organisations are innovating. Whilst product improvements might be delivering against an immediate customer need they can often miss a wider opportunity to open up new markets. The use of smaller disk drives in products such as the Apple iPod was a great example.

Levers and benefits of resilience

In combination, these six traits effectively make up the business immune system, enabling it to shrug off illness, bounce back and enable adaption to change. To develop and sustain them, companies need to pull the right levers. We've identified five broad groups of levers for resilience, shown on the right-hand side of Figure 4. They are:

Identity

The elements that describe the alignment of the organisation's purpose, vision and values with the culture and behaviours of its employees. An organisation that says one thing and does another will not be resilient.



Context and environment

These elements include the horizon-scanning, situational awareness and anticipation that enable an organisation to be responsive to change, and the connectedness of its relationships, including internal networks that link strategy with operations.



Leadership

The quality of the organisation's management and governance processes, along with the discipline they apply to stress-testing strategy and driving innovation.



Value protection

The traditional elements related to operational risk management. Whilst these are important, an over emphasis on these elements, or lack of alignment between them will harm an organisation's overall resilience.



Capability and Capacity

These elements provide the underpinning resources required to support an organisation today with the flexibility and agility to support future aspirations.



Each organisation will need a different balance between these factors to make it resilient. However, the benefits of striking the right balance are remarkably consistent. Those that achieve this will be positioned to build resilience in the long term, by spotting the weak signals that indicate a future problem or opportunity, being quick to identify the

need to change minimising the cost and disruption caused by knee-jerk transformation, and where it is required, ensuring change is delivered smoothly and in a way that supports the organisation's long-term aspirations. Getting this right will protect their reputation and ultimately generate higher returns on investment.

The moment of truth for corporate governance



While resilience is a desirable quality, it's questionable whether an organisation that has never had to ride out a crisis can truly claim to be resilient. That said, there can be very few long-standing businesses that have never encountered a crisis that could fundamentally endanger their reputation and licence to operate.

The fact is that boards can put in place all the components of corporate governance needed to achieve resilience – the right tone, culture, risk appetite, controls, and more – and crises will still happen. Being resilient will help them to bounce back and, if necessary, transform themselves in response.

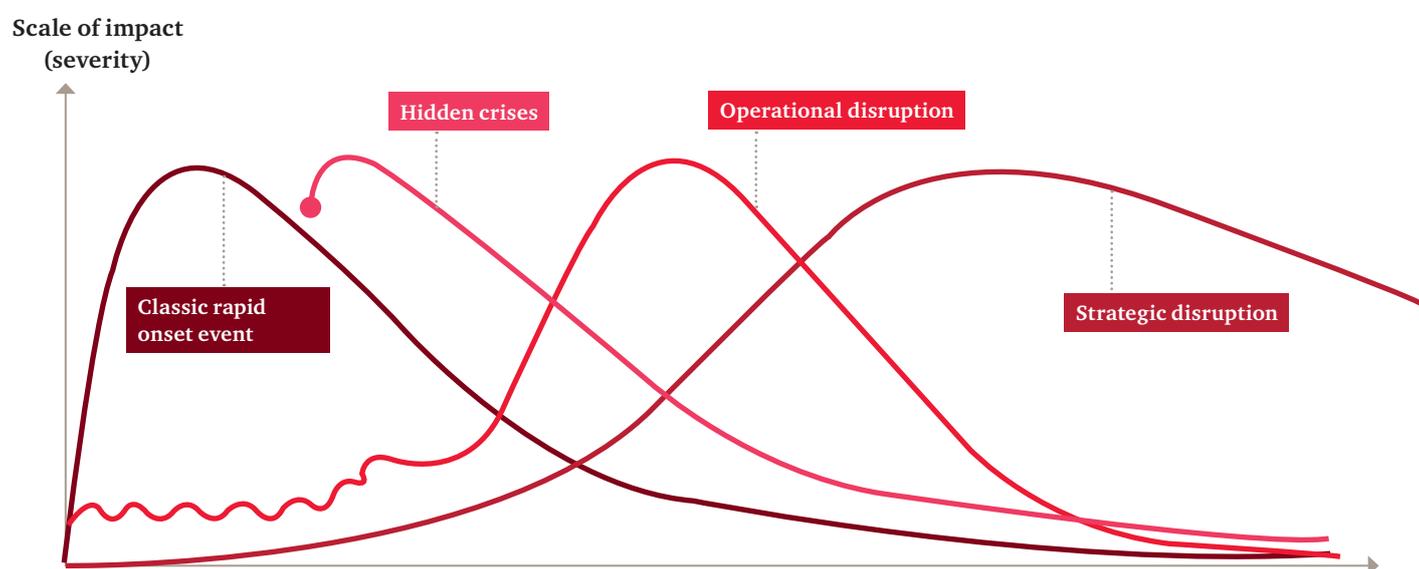
Four types of crisis

The Roads to Ruin and Roads to Resilience studies provide valuable guidance for boards seeking to create corporate governance environments that foster and embed resilience into their organisations. An especially important point is the emphasis on culture and behaviour as the principal source of resilience.

However, it's also vital for boards to recognise that all crises are not the same. This means a 'one-size-fits-all' approach to preparing for – and responding to – crisis situations will inevitably fail to address the full array of causes, consequences and twists and turns that can emerge.

PwC's experience and thinking have found that there are essentially four types of crisis. As Figure 5 shows, these are all different – not just in terms of their causes, but also in the speed with which their full impact emerges. So as well as remaining vigilant for sudden unexpected events, the board also needs to stay alert to slow-burn situations that could suddenly explode into disruptive risk events.

Figure 5: Time/severity profile of four types of crisis



1. The first type of crisis is the **classic rapid-onset crisis**, such as a physical disaster or business continuity breakdown. In many ways, these are the easiest to identify and tackle: something big has happened, and a senior response is imperative – and urgent.
2. The second type of crisis is more challenging: **operational disruptions** – such as supply-chain failures, IT outages, or health and safety failings – that can rumble along quietly while building up catastrophic event risks in the background. Think rail maintenance: one of a series of apparently low-level issues suddenly ticks upwards to trigger a full-blown crisis, apparently with little warning – although the signs were actually there all along.

3. The third category is **hidden crises** that can suddenly explode into view, such as serious frauds or ongoing ethical breaches. These take a similar path to the major physical events, but their onset is concealed until they spring up.
4. Finally, there's the **long-term strategic crisis** that builds up slowly over time, to the point where the organisation's very operating model is challenged and sometimes tipped over the edge. Think Kodak's camera film business or Blockbuster's video rental stores.

So faced with these four types of potential crises, what can boards do? In summary, one area of focus for each type of crisis:

- Business recovery plans, which have been rehearsed, tested and communicated, are essential to mitigate the classic rapid onset event.
- Horizon scanning, scenario planning and linking risk and strategy together will provide a lens on potential strategic disrupters.
- Maintaining discipline, a strong compliance culture and a joined up view of the overall organisation will help prevent operational issues becoming operational disrupters.
- Keeping a focus on the relevance of the value and behaviours of the organisation and ensuring they are consistent with the values expected by society today, will help to avoid hidden crises.

Ultimately, people matter most

While these types of crisis differ in nature, origin and time profile, the board that has implemented effective corporate governance will be better placed to respond in the best way to each. This is where the true value of

leadership comes to the fore, providing a clear and explicit purpose, vision and values – all demonstrated and reinforced by the right behaviour and culture, defined as ‘the way we do things around here consistently’. In trying to drive

improvements in these areas, the place to focus initially is behaviour, since – unlike an embedded culture – it can be changed virtually overnight.

Figure 6: The drivers of behaviour in an organisation



Figure 6 shows the levers at the board’s disposal to help ensure the organisation’s people behave how it wants them to.

Intrinsic Motivators

To establish and use these levers, the board should start by looking at the Intrinsic Motivators and applying its board mandate to clearly articulate the organisation’s purpose and vision; then convert the purpose and vision into explicit values; and finally use these values to define the behaviours it wants people to enact across the business.

If these four intrinsic motivators – purpose, vision, values and behaviours – are in place and aligned in the right direction, experience suggests that most people in an organisation will behave in the way we want. As the positive behaviours become increasingly embedded, the result can be a virtuous circle where doing the right thing becomes the accepted cultural and behavioural norm rather than something imposed from above.

Reinforcers

In our view, six components play a role in helping to reinforce and embed the right behavioural norms across a workforce. In order of importance, they are:

- 1. Tone from the top** – how leadership conducts itself and what it says.
- 2. Consistent communication** – both internal and external, verbal and written, and behavioural.
- 3. Organisational structure** – free of silos that could make people prioritise their own sectional interests over those of the business as a whole.

4. Performance measures – monitoring and recognising the right behaviour as well as the right financial outcomes.

5. Rewards – incentivising and rewarding the right behaviour as well as the right financial outcomes.

6. Competitive pressures – resisting the temptation to behave inappropriately even if competitors are doing so.

In combination, these six components shape behaviour at the moments that matter – and the board that succeeds in aligning them can achieve both higher performance and better behaviour. For the board to generate these outcomes, it is vital that it gains ready and ongoing access to the broadest possible range of perspectives and views on the business. This means encouraging and facilitating frank, open and two way conversations with and between the full array of internal and external stakeholders – a point stressed by Tomorrow's Company (see information panel). Only through such conversations can the board hope to gain a comprehensive all-round view of its business's risks and opportunities with the ultimate outcome of heightened resilience and trust across all stakeholders.

The results

The litmus test for people's behaviour is the decisions they take at the moments that matter, when they have a choice between doing the right thing or not, and when there is probably nobody watching to compel them to do it. In other words, don't wait for a problem to arise – look to encourage proactive rather than reactive behaviours. Provided the intrinsic motivators and reinforcers are encouraging the desired behaviour, the odds are that the decision they take will be the right one for the organisation as a whole.

Tomorrow's Company: The importance of board conversations

'The fundamental precept of the board as a governance tool, whether unitary or supervisory, is the belief that the best way to lead an enterprise is in the interchange and sharing of facts, ideas and perspectives between the managers of the business, who know its nooks and crannies, and outsiders, who know less but have more detachment and objectivity. The medium for making that interchange happen can only be conversation. There is no alternative. The options are restricted to whether or not a subject gets suitable airtime, and whether the quality of the conversation about it is good or bad.'

Tomorrow's Company:
**'Tomorrow's Corporate
Governance: Improving the
quality of boardroom
conversations'**

Building trust and culture



The right culture & behaviours

While the right culture and behaviour are vital for corporate governance to be effective, any effort to drive improvement in these areas across an organisation raises an obvious question: how do we know whether it's working? One way for the board to find out could be to wait and see if a crisis blows up (or not) caused by poor behaviour. But a far better and less risky approach is to measure culture on an ongoing basis.

Before it can measure culture, the board has to start by defining it. PwC generally defines culture as 'the assumptions or beliefs common in an organisation that predict how its people will behave and what it will achieve'. It clearly isn't possible to measure assumptions or beliefs. But the behaviours and outcomes they produce can be measured.

This measurement can take place in three dimensions:

- 1. What we want** – the behaviours the organisation expects in order for its vision and values to be achieved.
- 2. How we set ourselves up** – the processes, policies and controls that the organisation creates to influence people's behaviours, including reward policies and leadership communications.
- 3. What we get** – what are people doing? What decisions are they making? What are they prioritising? Focusing on scenarios involving trade-offs that impact outcomes and culture will make the measurement more meaningful.

Aligning these three aspects of behaviour is the key to successful culture change. Even when values are clearly articulated, they don't necessarily generate the right behaviour at moments that matter. If there is a mismatch between the intended, espoused and actual behaviours, the organisation will underperform commercially and lose trust among stakeholders. If they're aligned, both performance and trust can – and probably will – grow.

Investing in your trust asset...

This brings us back to the core purpose of corporate governance: managing and explaining the business in a way that is aligned with its core purpose and builds trust among all stakeholders. And trust is not an asset to be taken lightly. PwC's Trust Insight research looks at the value of being a trustworthy organisation and measuring the drivers that influence trust with different stakeholder groups. The findings indicate strongly that investing in trust as an organisational asset can drive performance for any business and can help organisations achieve their strategic goals.

The trust engendered by good corporate governance is also instrumental in achieving resilience, because when a crisis hits an organisation they trust, stakeholders will give it the benefit of the doubt, and more time and leeway to sort its problems out. However, as we pointed out in a 2013 paper entitled 'Integrity, business ethics and the resilient organisation', the drivers of trust are constantly changing (see information panel). Boards should strive to keep pace with this evolution through stakeholder conversations and horizon-scanning.

The shifting parameters of trust

'As well as managing the different levers to nurture the right behaviours and build organisational resilience, boards must also take account of a further critical dimension – which is the constant evolution in the criteria against which society judges companies' trustworthiness.'

“Integrity, business ethics and the resilient organisation”, PwC

...and ensuring compliance

However, while the drivers of trust may change over time, a consistent imperative for trust to develop and grow is regulatory and ethical compliance. So, to ensure that corporate governance does its job, boards must be continually aware of the level of compliance throughout their organisation. By applying a compliance lens to the right information, they can be assured that the governance framework is effectively translating the board's mandate, purpose and values into people's everyday behaviour on the ground – and also that this behaviour is compliant.

The scope and nature of compliance has evolved from a series of rules-based regulations to a much broader, greyer area that now includes operational, customer and third party risks which have become more complex and entwined – areas that are more difficult for companies to monitor and control.

Compliance risk also touches many functions and over time multiple compliance initiatives and structures are created across operational, financial, regulatory, ethical and legal departments. This is understandable given the significant changes to the regulatory and ethical compliance landscape, from the Sarbanes-Oxley Act to the rise in anti-bribery legislation and the renewed focus on Data Privacy.

The accumulation of such compliance teams – all performing similar compliance activities and processes – can result in bureaucracy, inconsistencies and compliance fatigue among front-line management subjected to repeated intervention and disruption.

So are organisations doing too much or are they doing too little? This is not a question on the volume of compliance activities, instead it's the efficacy of such activities, how they are structured, organised, deployed and more importantly how they are integrated into business as usual.

Eight tips for successful compliance

Be proactive

Take a proactive approach to compliance that addresses present and future compliance needs. This frees up leadership time to invest in the business and confidently exploit new market opportunities. It also helps to bring an ethical reputation, not only with regulators but also with customers, suppliers and wider stakeholders.

Make best practice for purpose

An integrated compliance framework is founded on fundamental components that collectively deliver an effective and efficient compliance organisation and culture. These components vary in complexity and depth to reflect each organisation's risk exposure – but they remain integral to effective compliance capabilities.

Don't lose sight of the big picture

It can be tempting to focus on individual components – such as policy or training – to deal with a specific compliance incident or situation. But only by embracing an integrated compliance programme will you pinpoint root causes and embed a true compliance culture.

Align with business objectives

An effective compliance programme aligns its activities and focus with the business's objectives and strategy. Focusing on compliance with competition law during an acquisition trail, or on data protection as the business grows its offshore data centres, will position the compliance programme as a trusted adviser to strategic decision-making.

Make it sustainable

More often than not, the focus on achieving compliance targets is sustained for a year or two, but then drops off. Sustainability is a vital characteristic of a compliance programme, as it ensures that compliance investments continue to benefit the organisation and pay off over the long term.

Don't just assume it's working

A well-balanced monitoring and assurance structure is critical to any compliance programme. It enables issues to be detected and remediated early, facilitates the continuous improvement of the programme, and – more importantly – embeds compliance accountability across the business.

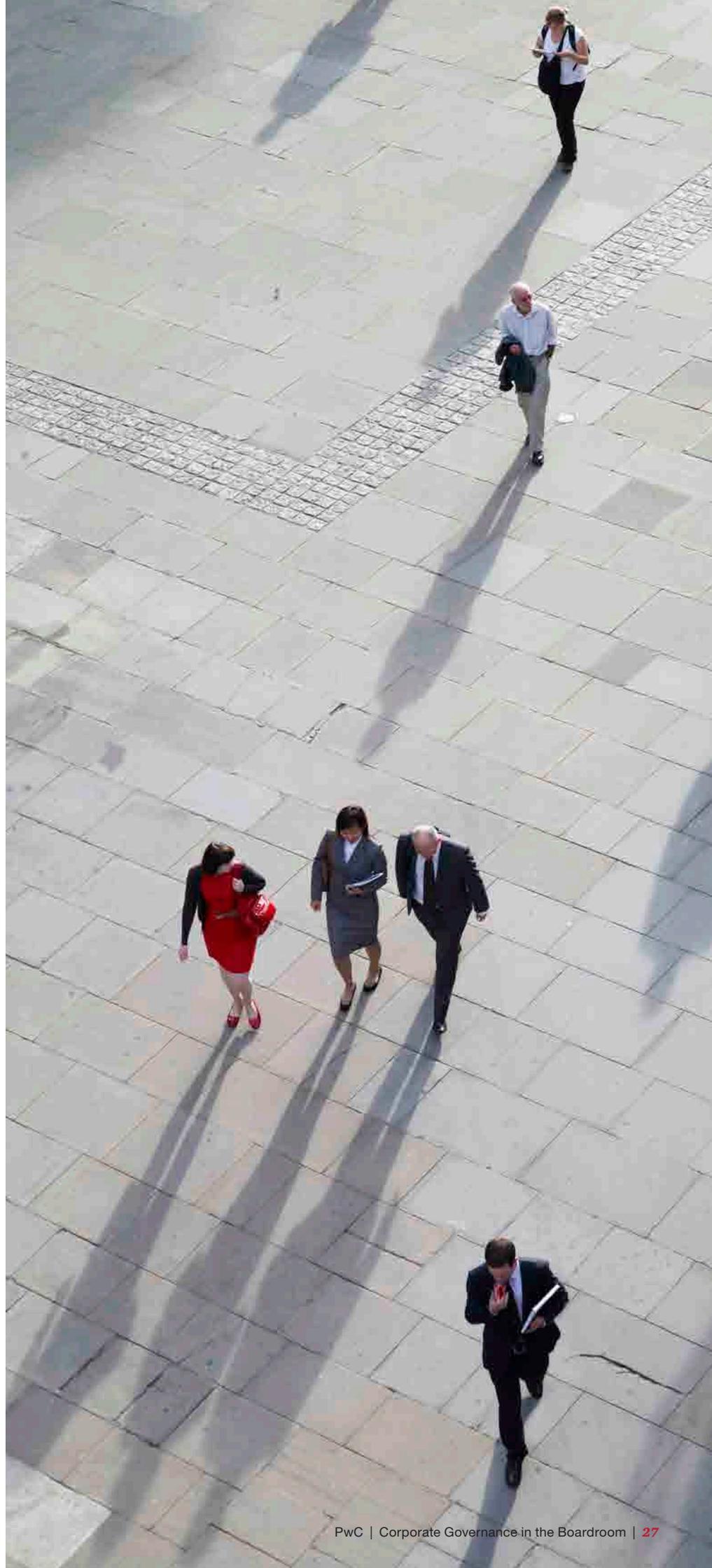
Compliance can feel like an unwieldy burden: executives and non-executives are overwhelmed by compliance information from multiple sources; the front line is overwhelmed by compliance tasks, risk assessments, audits and reporting requirements placed upon them by the different compliance teams; and the sustained focus on cost efficiency is putting pressure on the ethical and regulatory compliance teams to find synergies, adapt and take a more consistent approach. In response, many organisations are reassessing the effectiveness of their compliance capabilities and are looking for the most successful approach.

Keep it simple

With the constant increase in laws and regulations, businesses can adapt a reactive and siloed approach to compliance, resulting in duplication and 'compliance fatigue'. A leaner and simpler programme leads to more efficient processes, and is recognised by the business as an enabler not a distractor.

Communicate, Communicate, Communicate

Progressive compliance programmes have long recognised the importance of consistent and clear communication around their objectives. Some programmes have their own branding and corporate communication skills, while others use third-parties to source them.



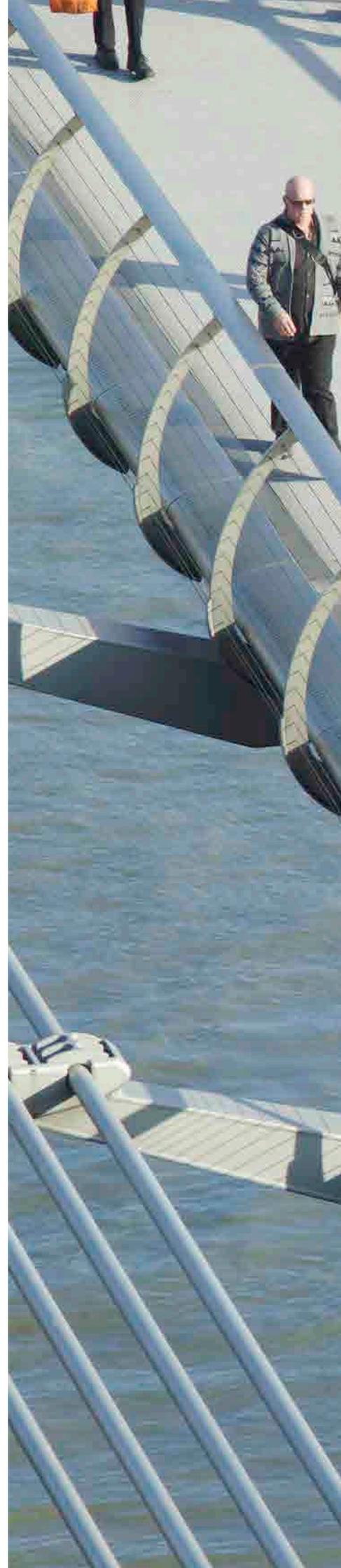
New approaches emerge

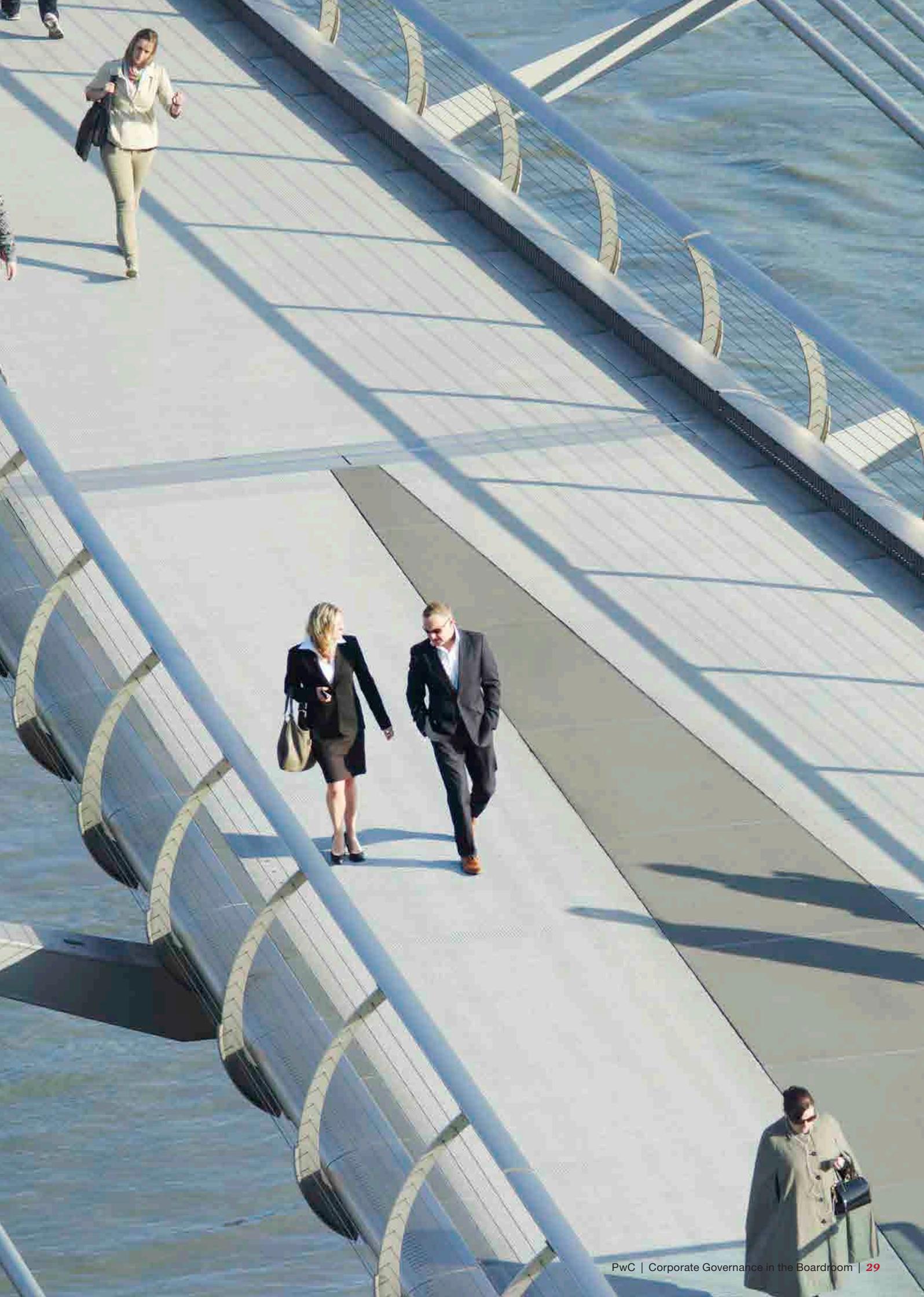
Now the tide is changing. Driven mainly by Boards and non-executives, we are seeing an increasing number of organisations striving and investing to develop and integrate their compliance capabilities to manage ‘business as usual’ compliance risk, while also identifying and improving the more overarching and fundamental ethical levers.

We believe that the future for many ethics and compliance functions will be building a simpler, universal and integrated framework that spans all compliance areas supported by one common tool to capture compliance requirements; risks, policies, procedures, controls, monitoring and

assurance activities. We are also seeing strong signs that the recent focus on corporate culture as evidenced by the updated UK Corporate Governance Code is here to stay – defining, shaping and monitoring the culture and behaviours across organisations. It’s no longer a ‘nice-to-have’ but a ‘must-have’.

Strong and continuously reinforced ethical cultures breed acceptance of ethical standards rather than resistance to them, as long as they are clearly aligned to the reputation of the company. They also breed ‘loyalty’ – an emotional bond to the organisation’s brand which is the strongest compliance tool possible; people are far less likely to intentionally damage a brand they hold an affection towards.





***So what could
tomorrow look like?***



The rise of ‘risk leadership’

If boards are able to create, embed and sustain the type of corporate governance that we’ve described in this paper, then we think this opens the way to a new and different future: one in which organisations – and their people at all levels – truly understand both the critical role of effective risk management in a turbulent and uncertain world, and also the opportunities for their businesses to adapt and build capacity for survival.

This future could be one where there is a common understanding of risk throughout the organisation, where risk becomes the natural vocabulary used by everyone when thinking, assessing and acting upon decisions – ensuring that risk is taken seriously, acted upon and addressed – resulting in a partnership attitude of mind and behaviour that is embedded in the DNA of the organisation.

A vital enabler for this future is the emergence of a new form of risk leadership across all industries. This concept is explored in a recently-published paper from Tomorrow’s Company entitled: ‘Tomorrow’s Risk Leadership: delivering risk resilience and business performance.’ In line with the changes in corporate governance set out by the FRC, the publication puts forward the case for all organisations to rethink their risk leadership, and

consider the value of a dedicated executive risk leadership role, taking into account how risk is structured in the organisation and its risk maturity.

This type of role is described in the accompanying excerpt from the report. Crucially, Tomorrow’s Company stresses that the purpose of risk leadership is not about ‘removing the responsibility for risk from members of the board. It is to help support them in managing today’s and tomorrow’s risk agenda.’ An important effect would be to help boards get an overall perspective on what is happening in the wider risk space, ensuring better-informed and more holistic decisions.

In PwC’s view, this compelling vision marks a logical next step in the evolution of corporate governance. The foundation and ultimate proof of effective corporate governance is behaviour – a fact that underlines the need for effective executive risk leadership. The best-governed and most resilient businesses of the future will be those where senior management takes a firm lead in forging a risk strategy that harnesses knowledge and ideas across and beyond the organisation, both to support the board and also to keep it fully informed about emerging risks. The risk leadership proposed by Tomorrow’s Company delivers on every count.

Tomorrow’s Company: defining tomorrow’s dedicated executive risk leadership

‘Having in place an executive voice of risk in the organisation that leads the risk agenda helps deliver the business model and drive business performance.

This leadership is achieved through being both a voice of challenge and a business educator and enabler, fully empowered to help the business gain a deeper appreciation of the relationship between risk, reward and strategy to enable better and more informed decisions to be taken.

It involves embedding a risk culture to help the organisation proactively deal with risk issues and inherent dilemmas, across and beyond the enterprise.

To be successful they must be able to see, and integrate the whole risk agenda for the business, aligned to its business model, and navigate this agenda over immediate and longer term horizons, with independence and assuredness. This involves having a strong forward looking and external focus, scanning the business environment for risks and opportunities that can impact business performance.’

‘Tomorrow’s Corporate Governance: Tomorrow’s Risk Leadership: delivering risk resilience and business performance’

At PwC, we’re continually engaging with boards and leadership teams on these issues, aiming to help them align their organisation’s board mandate, strategy, risk appetite and behavioural culture in a way that enhances governance and supports their journey to resilience. Throughout this journey, the key to tomorrow’s successful, well-governed company is robust leadership of the risk agenda. In a world of ever-more diverse and unpredictable risks, that’s the one vital factor that will increasingly define and differentiate the best corporate governance.

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