EMBRACING CHANGE
Boards need to ensure a culture of innovation and value creation to thrive

Governance 4.0 Redefining & Reinventing Governance

Embracing integrated thinking is key to sustainable corporate practices

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We are living in the fast-changing world of the 21st Century – evolving at such a neckbreaking speed that it is resulting in a so-called VUCA world, that is volatile, uncertain, complex and ambiguous.

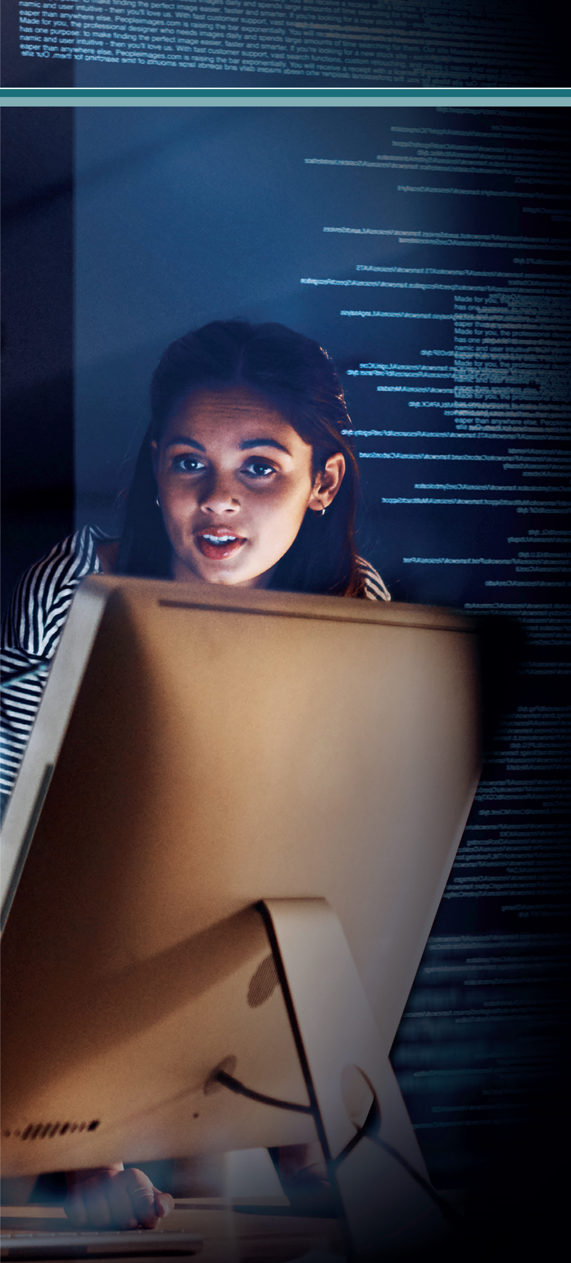
Due to these disruptive elements, corporate leaders are required to refocus their strategic vision and direction in order to remain relevant. The lifespan of a S&P 500 corporation today is significantly shorter; in the 1980s it was 75 years, but now it's down to 15 years and declining. No industry is immune to this disruption.

At the 2016 World Economic Forum, the Fourth Industrial Revolution or 'IR 4.0' was etched into the lexicon of the corporate world. Governments and private sectors of first world and developing nations have embraced IR 4.0 as the strategic thrust for their economies. But, what is IR 4.0?

Industry 4.0 refers to a new phase in the Industrial Revolution that focusses heavily on interconnectivity, automation, machine learning and real-time data. While every company and organisation is unique, they all face a common challenge – the need for connectedness and access to real-time insights across processes, partners, products and people. From board governance perspectives, silo thinking is obsolete; to survive and remain competitive, boards must embrace a new framework based on integrated value-creation thinking. Board oversights of the holistic, digital-driven business ecosystem in our disruptive environment is what we aptly term 'Governance 4.0'.

The fiduciary duty of the board has gone far beyond the traditional supervision of the company's financial performance as overseen by external auditors. It is imperative that directors appreciate the market-led, changing definitions of the resources entrusted to them. These include a redefiniton of assets, capitals, future workforce, digital disruption, paradigm shift in corporate reporting, and so on.

Assets as reflected in financial statements are transactional tangible assets only. As such, the significant value of data that



is viewed as 'intangible' is simply ignored in these statements. Yet in today's economy, markets view data as one of the most prized assets.

In 2014, it was reported that WhatsApp, a messaging app company, recorded an accummulated loss of $232million. Yet, it was acquired by Facebook for $22billion. What did Facebook see that financial experts failed to account for? It is data… 300 million messages exchanged daily at the time, which has now grown to more than 1.5 billion active users texting over 65 billion messages daily, yet this incredible value is still not reflected in any financial statement!

Studies consistently prove that more than 80 per cent of the market value of S&P 500 companies today comprise of intangible assets, especially in technology sectors. Even the risk industry is confronted with the onslaught of 'intangibles' that often distort the basis and validity of pricing the risk elements. As Greg Case, Aon CEO, said at the company's Q3 2018 earnings call: "The risk industry has to keep up with a constantly evolving environment in a daily battle for relevance. As an industry, we have not kept up with a world where 75 per cent of market capitalisation is now driven by intangibles assets." The board would have failed to duly discharge its fiduciary duties if it did not clearly disclose the limitation of the financial statements to the investors vis-à-vis the market value of the company.

No one disputes the importance of investing in human capital and R&D; yet by today's accounting standards, such investments are considered expenses. The more we allocate resources to such investments, the more the company's bottom-line is adversely impacted. Yet, the company would surely perish were it not to invest in its human capital.

The board's duty of care goes beyond the traditional reliance on outsourced expert opinion. Being aware of the limitation of audit assurance that is guided by established accounting and auditing standards, it is incumbent on the board to raise pertinent questions regarding the scope of the audit vis-à-vis the market value of the company. If the audited financial assets is significantly less than the company's market value, there needs to be a rational, analytical basis to explain the difference.

Reporting decisions

From a big-picture perspective, the governing purpose of a corporate audit report is to give assurance to investors that the financial performance of the company is true and fair. The robust regulatory framework for financial reports ensures the interests of investors are safeguarded by the independent assurance of external auditors. However, do we know how much investors rely on the financial reports to make forward, informed investment decisions? A well-documented research by Prof Baruch Lev and Associate Prof Feng Gu in their book *The End of Accounting* indicates that investors rely on financial reports less than five per cent of the time when making investment decisions, which is understandable because by the time any audited financial report is published, it's already outdated. More than 70 per cent of the time investors lean on unaudited sources, such as media reports, market intelligence, industry insights, government statistics, analyst forecast, and so on. Investors, being pragmatic and judicious, rightfully raise questions regarding the value of audits beyond merely fulfilling compliance requirements.

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The board is often pressured to file the company's quarterly financial report in compliance with established regulatory frameworks. In today's highly disruptive environment, one should question the value of such an exercise that tends toward a mindset of short-termism. The constantly changing business landscape also demands greater disclosure in areas such as the company's strategies regarding the environment, sustainability and climate change, to name a few. So, with the increasing demand on the board for greater disclosures in corporate reporting, what should the board focus on?

The board as a whole is a strategic asset to the company with fiduciary duties to safeguard, add and create value of the assets and capitals entrusted to it. While the importance of regulatory compliance should not be underestimated, these are already delegated to qualified professionals, such as external auditors, corporate secretaries, corporate counsels, etc, to keep the company's business activities and the board on the straight and narrow. However, the board's fiduciary oversight responsibilities still remain and cannot be delegated.

As strategic assets operating in a VUCA environment, boards need to oversee their organisations' capacities to do a better job of assessing disruptive risks, whether internally or externally driven. These risks could have significant economic, operational, and/or reputational impact should they occur. The task is not an optional undertaking for directors: it is a critical imperative because these types of risks are often ambiguous, complex, and difficult to identify. To assess and respond to these risks will require building proficiency in what is called 'adaptive governance' – as a necessary response to a world in continuous disruption. A culture of innovation and a culture of value creation are the two-prong approach for thriving in a world of change.

Regardless of market disruptions, the board's top priority is to create value with the capitals and assets entrusted to it – conveying to investors a more holistic message on the output of its fiduciary responsibilities. A trending corporate strategy is the adoption of an integrated value creation-thinking framework on how the board creates value with the essential capitals under its care. The output-focussed integrated reporting (IR) framework, developed by the International Integrated Reporting Council (IIRC), is gaining traction toward a paradigm shift in the traditional financial corporate reporting to holistic Integrated Reporting. This will redefine and reinvent the governance framework as we know it.