The swinging pendulum: Board governance in the age of shareholder empowerment

Governance **Insights** Center

PwC's 2016 Annual Corporate Directors Survey

October 2016

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Note: Charts may not all add to 100% due to rounding

Introduction

Against a backdrop of cheap oil, low interest rates, and record high US equity markets, the corporate governance environment for public companies continues to evolve in 2016. And by almost every measure, investors are now exerting more influence than ever on how boards and management teams operate. In some ways, the pendulum has swung from a 'board-centric' model that took root after the governance and accounting scandals of the 1990s to an 'investor-centric' model today—in which institutional investors and shareholder activists have an unprecedented say about board composition, executive compensation, and even how companies choose to allocate their capital. With these observations in mind, we structured PwC's *2016 Annual Corporate Directors Survey* to gauge director sentiment on board governance in this new age of shareholder empowerment.

The survey results clearly indicate that directors are being more responsive to investor pressure on a range of corporate governance issues.

Specifically, investors are having more of an influence in:

- **Suggesting new directors**
  There was a noteworthy increase in the percentage of directors who now say their board uses investor recommendations to identify new director nominees (18% this year, compared to 11% in 2012).

- **Changing board composition**
  More than six in ten directors say their board added a new member in the last year with a specific skillset, and nearly half say they added a diverse board member in response to investor pressure; 34% say their board added a younger director and 24% say they removed an older director.

- **Prioritizing board diversity**
  Increasing board diversity is on the agendas of many institutional investors. Perhaps not surprisingly, the percentage of directors who now view gender and racial diversity as very important director attributes increased over the last two years; 41% now consider gender diversity very important, compared to 37% in 2014. And 34% now consider racial diversity very important—up from 28% two years ago.

About the survey

In the summer of 2016, 884 public company directors responded to PwC's *2016 Annual Corporate Directors Survey*. Of those directors, 71% serve on the boards of companies with more than $1 billion in annual revenue. Participants were 83% male and 17% female —closely aligning with the gender distribution of public company directors. The board tenure of participants was dispersed relatively evenly, and participants came from more than two dozen industries.

In some ways, the pendulum has swung from a 'board-centric' model that took root after the governance and accounting scandals of the 1990s to an 'investor-centric' model today.

- **Deciding how capital gets allocated**
  Investors increasingly feel empowered to influence how companies allocate their capital, and are pushing them to take specific actions. Nearly half of directors say their company increased share buybacks as a result of actual or potential investor demands and another 38% say their company initiated or increased dividends. In addition, 27% say their companies decreased corporate investments as a response to investor pressure.

- **Normalizing director-investor communications**
  A greater percentage of directors are now inclined to view direct engagement with the company's investors as appropriate. And the percentage of directors who consider particular topics not appropriate for direct communication decreased almost across the board.

- **Sharpening board performance**
  Eighty percent of directors at least somewhat agree that shareholder activists compel companies to more effectively evaluate their strategies, execution, and capital allocation. A similar percentage at least somewhat agree that shareholder activism has resulted in improved company operations and capital allocation.

- **Adopting proxy access**
  By the end of the 2016 proxy season, more than 40% of the S&P 500 had adopted a proxy access bylaw, compared to less than 1% two years earlier. We anticipate this trend will continue, with more companies adopting proxy access bylaws that enable certain shareholders to submit a limited number of director nominees for inclusion on the companies' annual proxy statements. In addition, about half of directors indicated that they have no particular concerns with proxy access.

- **Driving enhanced proxy disclosure**
  In a number of areas, including executive compensation, board composition, and the role of audit committees, investors have pushed companies to enhance their proxy disclosures. And many boards have taken action to do so. For example, 62% of directors say their boards took action over the past 12 months to enhance disclosures about the company's executive compensation plan.

- **Promoting longer-term strategic time horizons**
  Potentially in response to investor requests that companies focus more on long-term shareholder value, 52% of directors now say their company's strategic time horizon is one to five years or greater, compared to 48% who said so in 2011.

- **Impacting executive compensation practices**
  Seventy-seven percent of directors at least somewhat agree that say-on-pay voting has caused their board to look at compensation disclosure in a different way, and two-thirds say it prompted their board to change the way it communicates about compensation. However, 72% note that say-on-pay voting has not had an impact on 'right-sizing' CEO compensation.

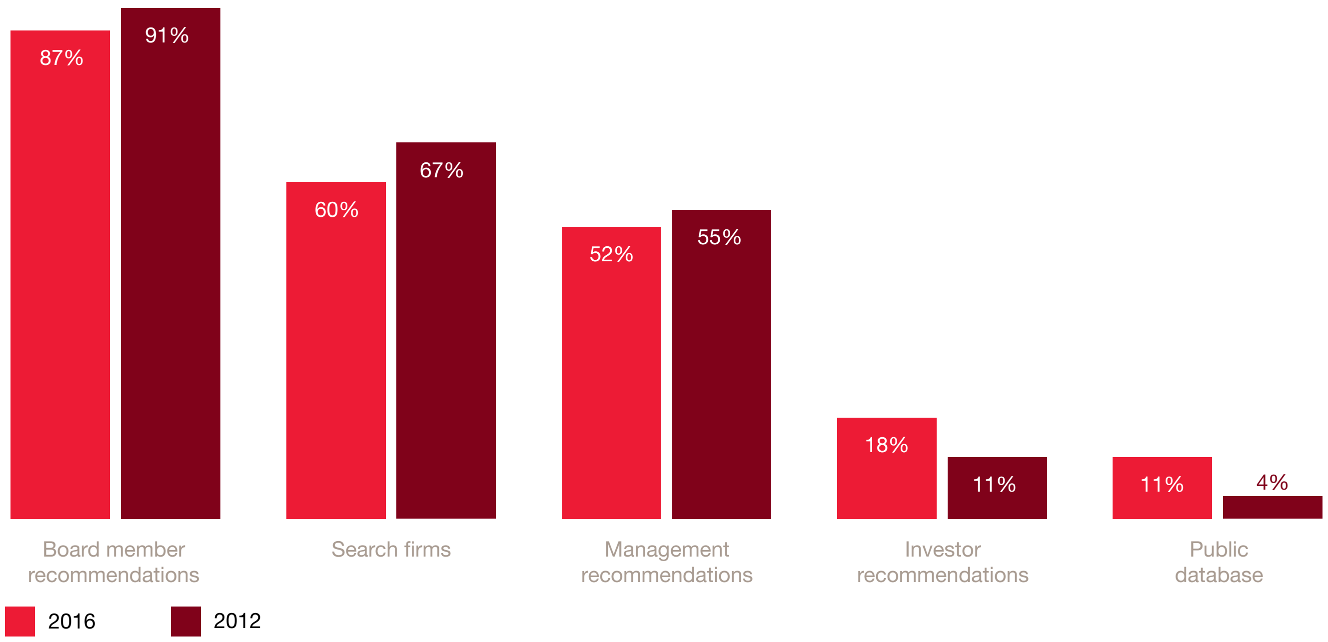
We invite you to review the full survey findings in the pages that follow.

Board composition and diversity

The search for new blood

While the recommendations of existing board members continue to be the most widely used source for identifying new directors, there was a noteworthy increase in the percentage of directors who say their board uses investor recommendations (18% this year, compared to 11% in 2012). This speaks to the increased influence of shareholders in the area of board composition. While still a significant source of new director candidates, there was a modest decline in the percentage of directors who say their board uses search firms (to 60% this year, from 67% in 2012).

What sources do you use to recruit new board members?



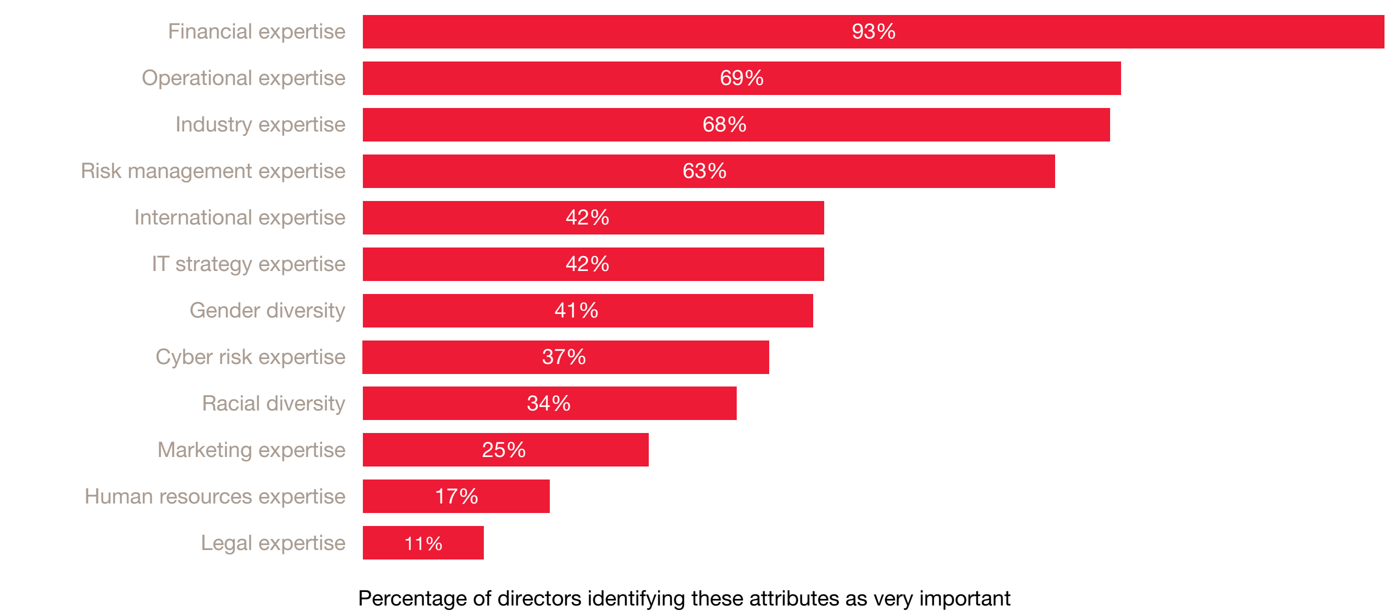
Bases: 884 (2016); 860 (2012)
Sources: PwC, *2016 Annual Corporate Directors Survey*, October 2016; PwC, *2012 Annual Corporate Directors Survey*, October 2012.

What director attributes are most important?

Consistent with results from the last several years, the most important director attributes continue to be financial expertise (93% describe it as very important), followed by operational expertise (69%), industry expertise (68%), and risk management expertise (63%). These core areas are fundamental to a board's ability to provide effective oversight. In addition, 37% of directors believe cyber risk expertise is a very important attribute. Human resources and legal expertise are less of a priority, with fewer than one in five directors describing these attributes as very important.

The percentage of directors who view gender and racial diversity as very important attributes increased over the last two years; 41% now consider gender diversity very important compared to 37% in 2014. And 34% now consider racial diversity very important—up from 28% in 2014.

How would you describe the importance of having the following attributes on your board?



Base: 863–868
Source: PwC, *2016 Annual Corporate Directors Survey*, October 2016.

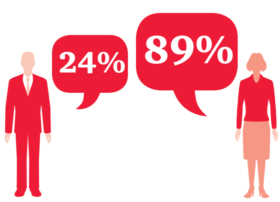
The impact of board diversity

While the vast majority of directors (96%) view adding board diversity as at least somewhat important, 83% at least somewhat believe there are impediments to doing so. They cite a limited pool of diverse director candidates as a significant obstacle; only about one-quarter very much believe there are a sufficient number of qualified diverse candidates. Female directors are more likely to believe there are a sufficient number of diverse candidates; 93% at least somewhat believe this to be true, compared to only 64% of male directors.

Despite the perceived difficulty of recruiting diverse board members, a majority of directors believe diversity positively impacts their board and company; more than eight in ten believe diversity at least somewhat enhances board effectiveness and company performance, and more than one-third believe it very much does so.

Deeper insights

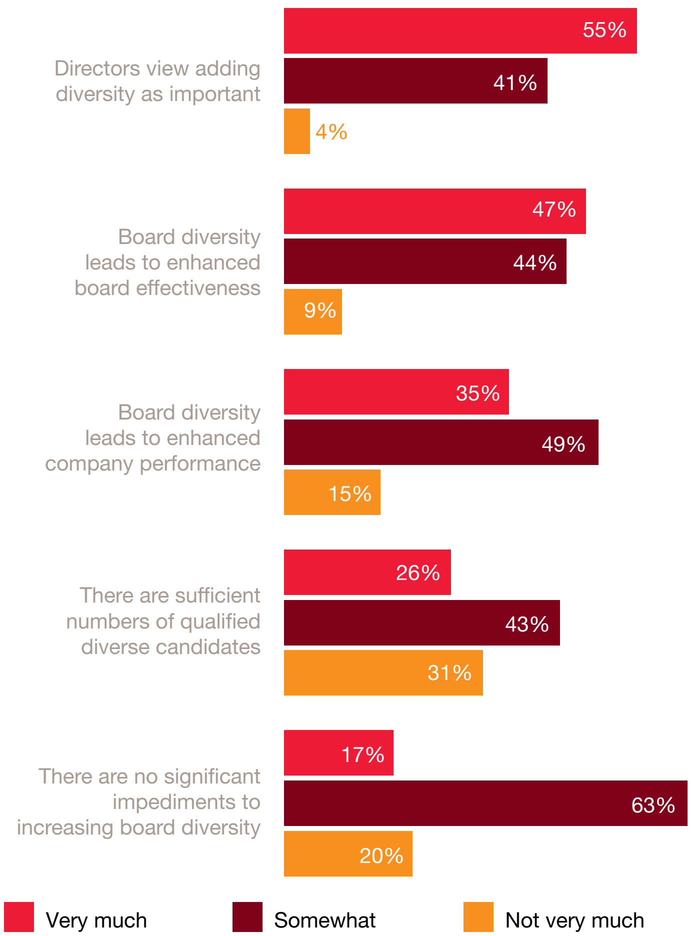
Female directors are much more likely to think board diversity enhances company performance and board effectiveness.



Board diversity improves
company performance

Board diversity improves
board effectiveness

To what extent do you believe the following regarding board diversity:



Base: 852-882
Source: PwC, *2016 Annual Corporate Directors Survey*, October 2016.

PwC perspective: *Board diversity*

One of the main impediments to building more diverse boards is that many boards look to current or former CEOs as potential director candidates. However, only 4% of S&P 500 CEOs are female,[1] and only 1% of Fortune 500 CEOs are African-American.[2] So in order to increase board diversity, the pool of potential director candidates needs to be expanded. To find more diverse candidates, boards will have to look in different places. There are often many untapped, highly qualified, and diverse candidates just a few steps below the C-suite—people who drive strategies, run large segments of the business, and function like CEOs.

While those who aspire to become directors must play their parts, the drive to make diversity a priority really has to come from board leadership: CEOs, lead directors, board chairs, and nominating and governance committee chairs. These leaders need to be proactive and commit to making diversity part of the company and board culture.

For more information on this topic, see our 2016 report ***Director-Shareholder Insights: Board composition–Key trends and developments***.

1 Catalyst, *Women CEOs of the S&P 500*, February 3, 2016.
2 "McDonald's CEO to Retire; Black Fortune 500 CEOs Decline by 33% in Past Year," DiversityInc, January 29, 2015.

The 'right' gender balance

Twenty percent of S&P 500 board members are female, and 31% of all new directors joining S&P 500 boards in 2015 were women.[3] But is there an optimal number of women that boards should be targeting in their overall composition? Some research has shown that Fortune 500 companies with the highest representation of female directors attained significantly higher financial performance, on average, than those with the lowest representation of female directors.[4]

An equal percentage of directors believe that 21–40% and 41–50% are the optimal ranges for female board representation. Both of these ranges, however, are notably higher than the actual percentage of women currently serving on boards.

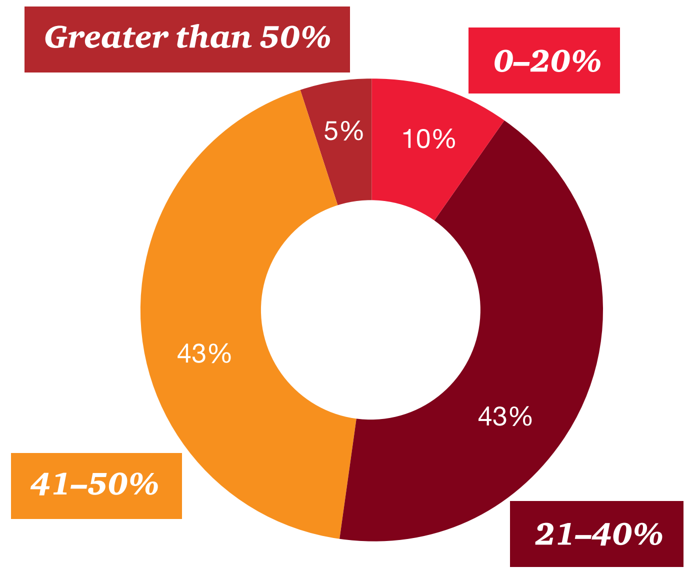
Deeper insights

One in ten directors** believes the optimal representation of **women on boards should be

20% or less

–97% of those who believe this are male.

What is the optimal percentage of female representation on public company boards?



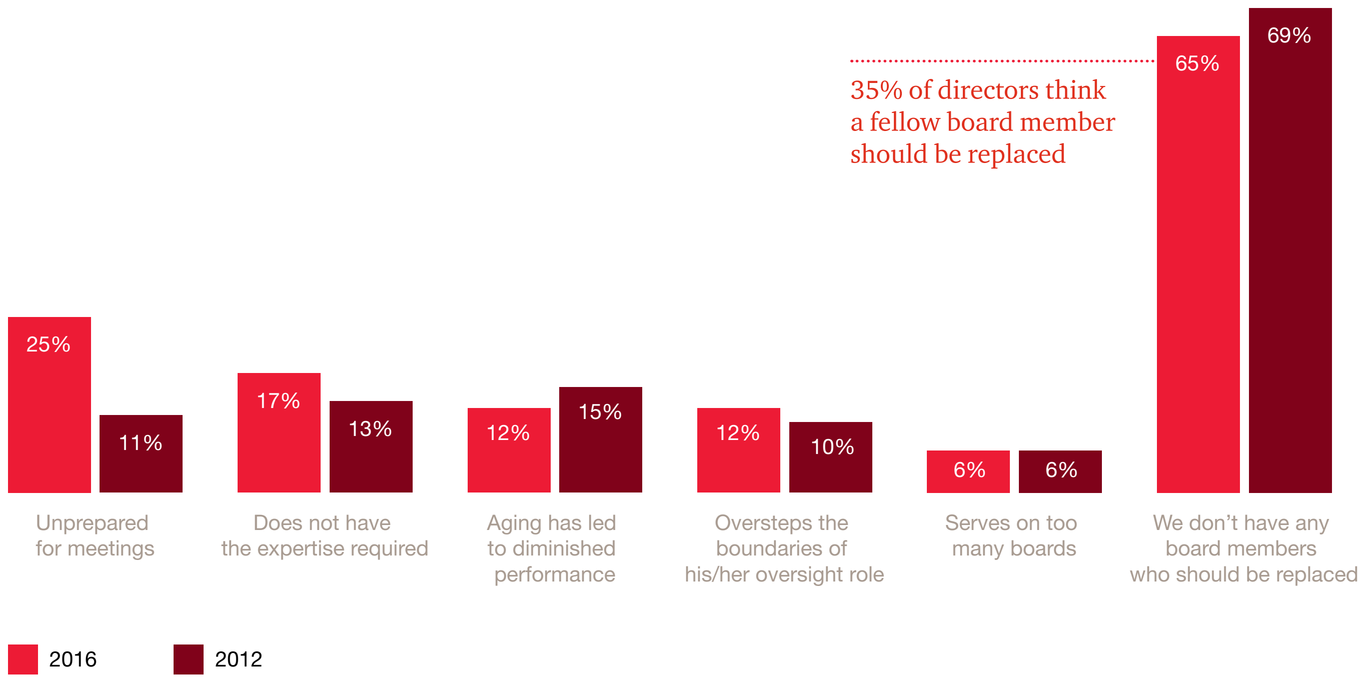
Base: 795
Source: PwC, *2016 Annual Corporate Directors Survey*, October 2016.

3 Spencer Stuart, *US Board Index 2015,* November 2015.
4 Catalyst, *The Bottom Line: Corporate Performance and Women's Representation on Boards (2004–2008),* March 2011.

Are you prepared for meetings? Dissatisfaction with peers

The level of dissatisfaction directors express with their fellow directors is higher today than in 2012; 35% of directors now believe someone on their board should be replaced—up from 31% four years ago, but down slightly from 2015. Directors continue to cite unpreparedness for meetings, lack of expertise, and diminished performance due to aging as the top reasons for wanting to replace their peers. Of particular note, the complaint that underperforming directors are unprepared for meetings spiked to 25% this year, up from only 11% in 2012. As the bar has been raised on director performance and pre-meeting materials have become more voluminous, the time commitment required for board work has increased accordingly. And some directors are clearly concerned that their colleagues are not keeping up.

Do you believe that any of your board members should be replaced for the following reasons?



Bases: 830 (2016); 852 (2012)
Sources: PwC, *2016 Annual Corporate Directors Survey*, October 2016; PwC, *2012 Annual Corporate Directors Survey*, October 2012.

Deeper insights

Directors with less tenure are more likely to think a fellow board member should be replaced;

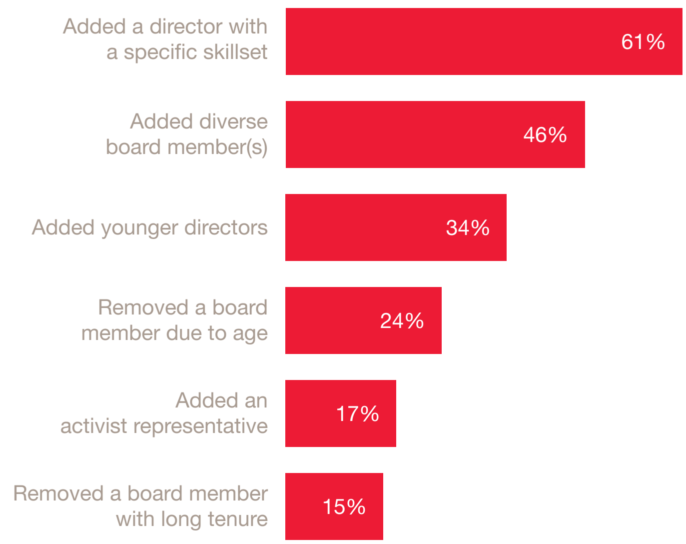
39% of directors *who have served on their board for two years or less think someone on their board should be replaced, compared to* ***29% of directors*** *with more than ten years of tenure.*

Investors flex their muscles on board composition

Directors are increasingly taking action to be responsive to investors about board composition. More than six in ten say that over the past year, their board added directors with a specific skillset, and nearly half say their board added a diverse director in response to investor pressure. Thirty-four percent say their board added a younger director and 24% say they removed an older director as a result of prodding by investors. Considering the aggressive shareholder activism environment of late, it's not surprising that 17% of directors say their board added an activist representative over the past year.

Investors are increasingly pushing boards to focus on their own refreshment. As part of that push, they are looking at director tenure and age. For example, the pension fund CalPERS (California Public Employees' Retirement System) believes that director independence can be 'compromised' after 12 years of board service, and in these situations, "*a company should carry out rigorous evaluations to either classify the director as non-independent or provide a detailed annual explanation of why the director can continue to be classified as independent.*"[5]

Has your board made any of the following changes to its composition in the past year in response to investor pressure?



Base: 412
Source: PwC, *2016 Annual Corporate Directors Survey*, October 2016.

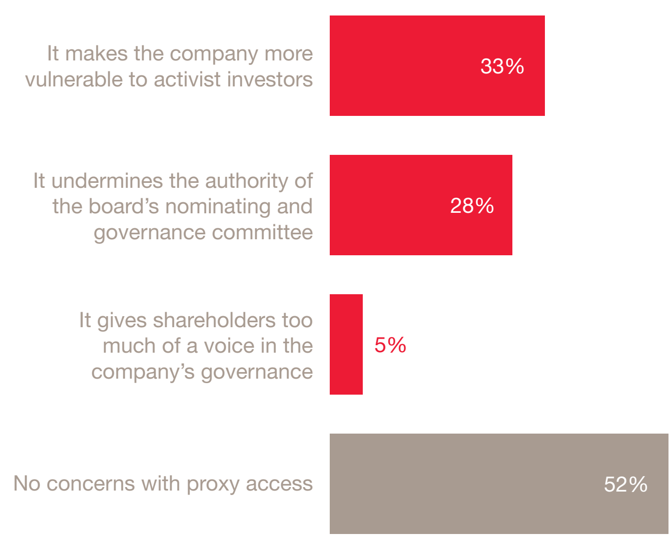
5 CalPERS, *Global Governance Principles,* March 2016.

Proxy access breaks through

2016 was a breakthrough year for proxy access—more evidence of increased shareholder empowerment. The Boardroom Accountability Project (a collaboration between the New York City Comptroller's Office and New York City pension funds) led the charge by filing 72 shareholder proposals for proxy access. A number of companies preemptively adopted proxy access bylaws, avoiding a shareholder vote. By the end of the 2016 proxy season, approximately 40% of the S&P 500 had adopted a proxy access bylaw,[6] compared to less than 1% two years earlier.[7] And we expect this trend to continue.

Director views are still mixed on proxy access. About half of directors have no particular concerns with proxy access. One-third believe it makes companies more vulnerable to activist investors and 28% believe it undermines the authority of the board's nominating and governance committee.

Do you have any of the following concerns with proxy access?



Base: 862
Source: PwC, *2016 Annual Corporate Directors Survey*, October 2016.

PwC perspective Proxy access

Many investors believe that proxy access is an essential shareholder right. They believe they need a mechanism by which long-term shareholders can directly influence board composition. And judging by the evolution of director views on proxy access, updates to investors' proxy voting guidelines, and proxy advisory firm voting recommendation policies, we anticipate that proxy access will continue to become more widely adopted over the next several years.

While one-third of directors believe proxy access bylaws make a company more vulnerable to shareholder activism, we do not necessarily believe this is the case. Most proxy access bylaws require share ownership of at least 3% of the company for three years. Our experience indicates, and the data shows, that activist investor timelines are generally 18 months or less. This would make activists' use of proxy access fairly unlikely.

If and when proxy access is used by institutional investors, we would expect it to be only in very narrow circumstances. Most institutional investors don't want to be in the business of nominating directors to the boards of the companies they invest in. With this in mind, we suggest companies reach out to key shareholders and evaluate whether adopting proxy access is appropriate.

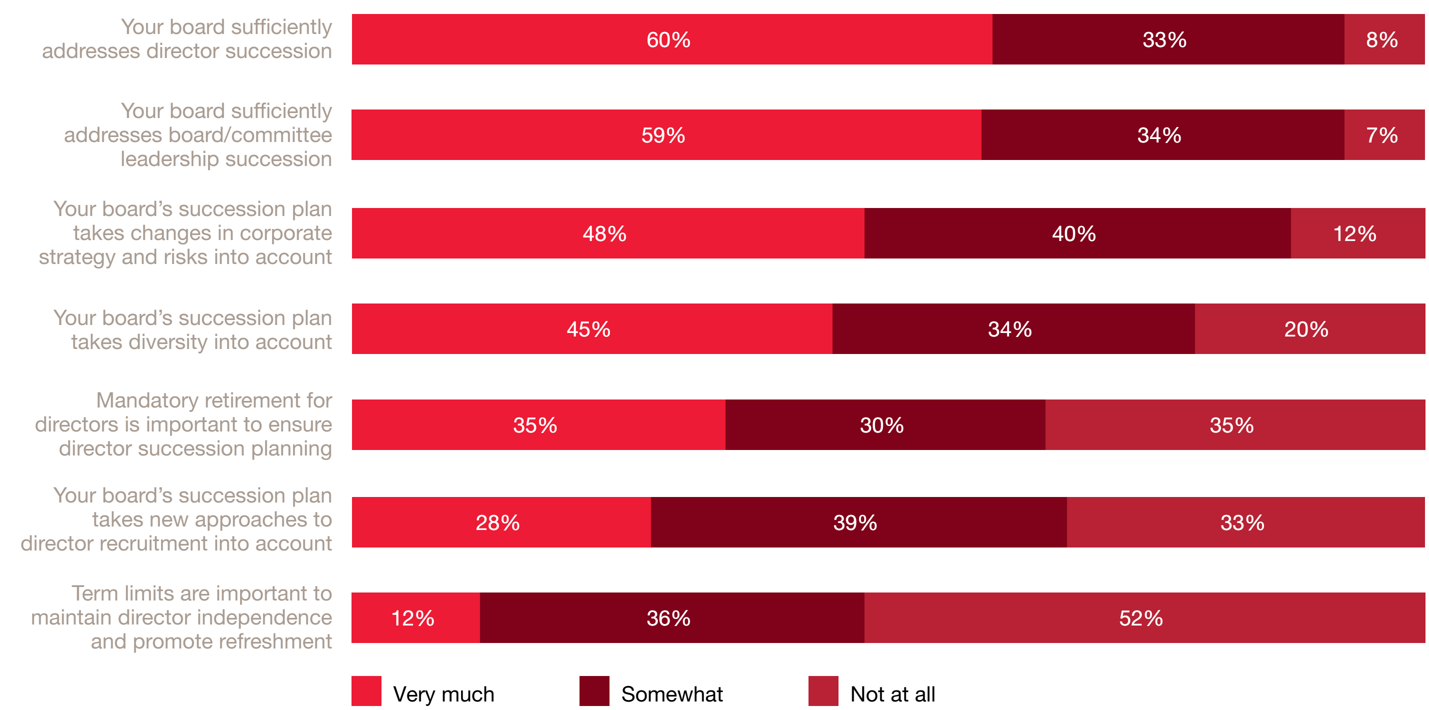
6 Sidley Austin, *Proxy Access Momentum in 2016,* June 2016.
7 Skadden, *Proxy Access: Highlights of the 2016 Proxy Season,* June 2016.

A focus on board succession

As shareholders continue to prioritize board composition, board succession planning has become increasingly important. On the whole, directors believe their boards are doing reasonably well in this area; about six in ten very much believe their boards sufficiently address director and board/committee leadership succession. Nearly half of directors very much believe their board succession plan takes changes in corporate strategy into account.

However, directors have more mixed feelings about the value of formal policies related to board succession—like mandatory retirement policies and term limits. Only 35% very much agree that mandatory retirement policies are important to ensure director succession planning and the same percentage don't at all agree. Only about one in ten agrees that term limits are important to maintain director independence and promote board refreshment.

To what extent do you agree with the following:



Base: 864–867
Source: PwC, *2016 Annual Corporate Directors Survey*, October 2016.

Deeper insights

Female directors are more likely to believe their board sufficiently addresses director succession, and place more importance on mandatory retirement policies for directors;

76%

76% of female directors *very much believe their board sufficiently addresses director succession, compared to* ***57% of male directors****.*

69%

69% of female directors *very much agree mandatory retirement ages for directors are important to ensure director succession planning, compared to only* ***29% of male directors****.*

Director communications and shareholder activism

Does director-investor dialogue actually matter?

The prevalence of direct communications between board members and investors has grown considerably over the last several years. More than half of directors now say their board has such engagement. But directors aren't overwhelmingly convinced that these dialogues are valuable, and question their impact on shareholder behavior.

Only one in five directors very much believe that the right investor representatives participate in the engagement. Only one in four very much believe investors were well-prepared for the dialogues; 37% say they were not at all prepared. Only about one-third (31%) strongly believe their boards received valuable insights from the process. In perhaps their harshest critique, only a small number of directors very much believe direct engagement with investors impacts either investing decisions or proxy voting (14% and 18%, respectively).

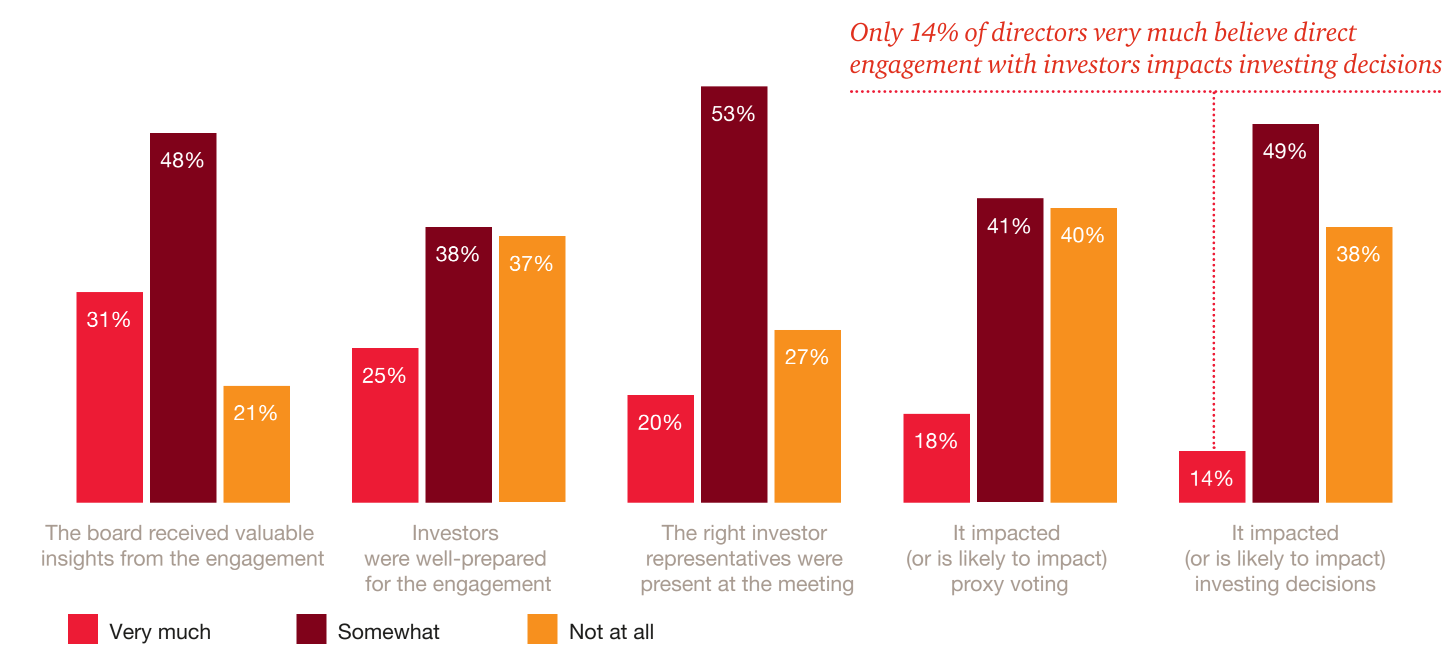
Base: 757
Source: PwC, *2016 Annual Corporate Directors Survey*, October 2016.

Deeper insights

Directors at the largest companies see more value in direct engagement with investors;

51% of directors at mega-sized companies very much think their board received valuable insights from direct engagement, compared to only 14% of directors at smaller companies.

To what extent do you agree with the following regarding your board's direct engagement with investors:

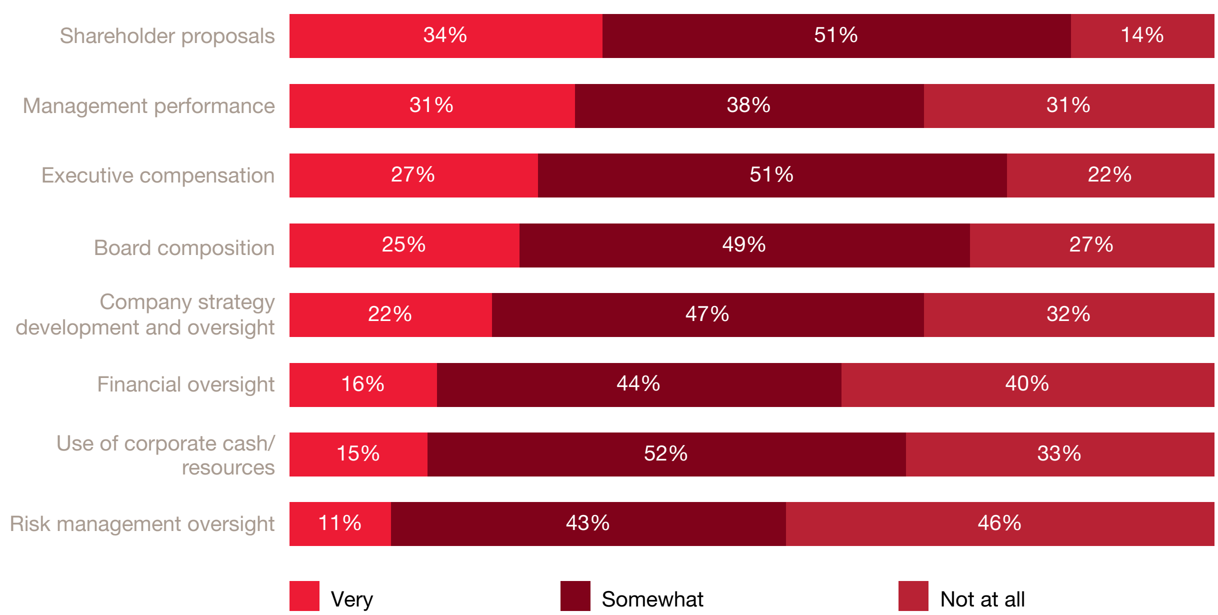


Base: 328–543
Source: PwC, *2016 Annual Corporate Directors Survey*, October 2016.

What topics are fair game?

A greater percentage of directors are now inclined to view direct engagement with shareholders on a range of topics as appropriate compared to two years ago. And the percentage of directors who consider topics not appropriate for discussion decreased almost across the board. For example, 78% of directors now believe it is at least somewhat appropriate to directly discuss executive compensation with shareholders, compared to 73% in 2014. Similarly, 69% of directors now believe it's appropriate to communicate directly with investors about company strategy—compared to 56% who did so in 2014. This trend may indicate a desire on the part of boards to get out in front of activist investors who frequently question the efficacy of a company's strategy as part of their campaign. Directors also grew more comfortable communicating about the company's use of corporate cash/resources. Directors are least comfortable discussing risk management oversight with investors despite their high degree of confidence in their board's ability to oversee risk (see page 28).

Regarding the following topics, how appropriate is it for boards to engage in direct communication with shareholders?



Base: 856–862
Source: PwC, *2016 Annual Corporate Directors Survey*, October 2016.

Making proxy disclosures more meaningful

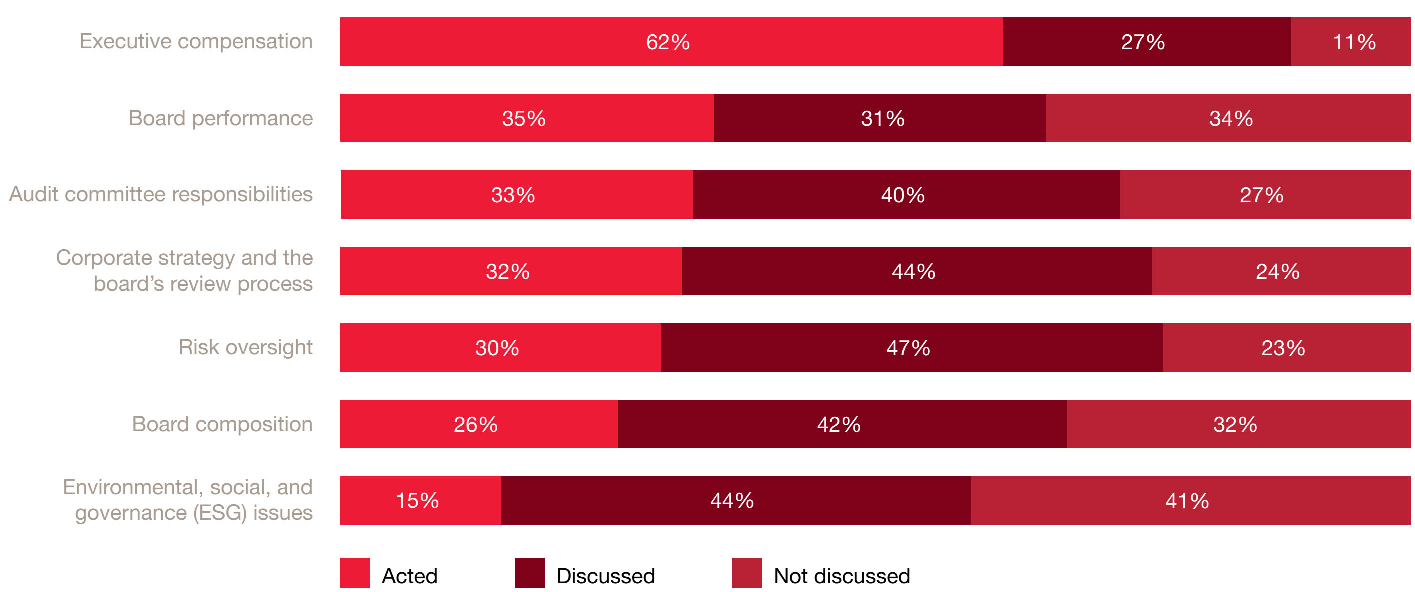
Investors have pushed companies to enhance their proxy disclosures to include more detail and be more meaningful. Many boards have taken action to do so—or are discussing it; 62% of directors say their boards took action over the past 12 months to enhance disclosures about the company's executive compensation plan. About one third say their boards have taken action to enhance the company's proxy disclosures related to risk oversight, corporate strategy, and the audit committee's responsibilities. ESG (environmental, social, and governance) issues are getting the least consideration for enhanced disclosure; 41% of directors say their board has not focused on these areas.

Deeper insights

Directors at mega-sized companies have taken more action to enhance proxy disclosures than those at smaller companies;

this is particularly true regarding executive compensation (82% vs. 48%), board composition (40% vs. 17%), and ESG issues (50% vs. 5%).

Over the past 12 months, has your board taken any action to enhance proxy disclosures related to:



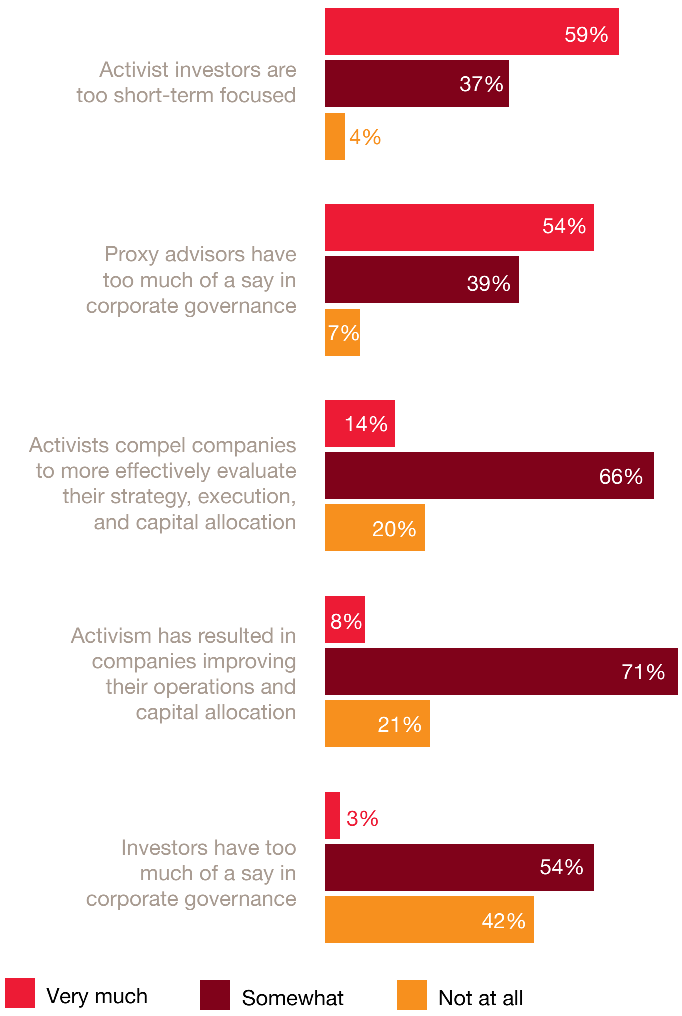
Base: 766–794
Source: PwC, *2016 Annual Corporate Directors Survey*, October 2016.

Are activist investors good for business?

Directors clearly view activist investors as too short-term focused; 96% at least somewhat believe this is the case. However, a majority of board members also recognize that activism has brought with it some positives; 80% at least somewhat agree that activism has compelled companies to more effectively evaluate their strategy, execution, and capital allocation. A similar percentage at least somewhat agree that activism has resulted in companies improving their operations and capital allocation. So despite concerns about short time horizons, many directors believe activists have actually been good for companies.

Directors are united in their views of proxy advisory firm influence; 93% at least somewhat agree that proxy advisors have too much of a say in corporate governance and 54% very much believe this. But directors have more mixed views on the influence that investors have on corporate governance. While 57% at least somewhat agree that investors have too much of a say in corporate governance, 42% don't believe this at all.

To what extent do you believe the following:



Base: 860–862
Source: PwC, *2016 Annual Corporate Directors Survey*, October 2016.

PwC perspective
Shareholder engagement and activism

Company management—and sometimes board members—should engage with their largest shareholders about company strategy (and the board's involvement), its capital allocation plan, how executive compensation is linked to strategy, and why the board is made up of the right directors to oversee the company into the future.

Companies will want to consider engaging with activists, too. Listening to what an activist has to say can prevent what could become an antagonistic situation down the road. Some companies have learned this the hard way. For example, after a year of recommending to a company numerous business and management changes—and being rebuffed—one activist successfully replaced the company's entire board.

Not all interaction with an activist is contentious; some companies negotiate with activists to prevent the disruption that comes with a long and expensive proxy fight, sometimes offering them a board seat. Others might learn from the different perspectives, ideas, and insight an activist brings to the table. Overall, the best practice when interacting with all investors—including activists—is to spend more time listening than presenting.

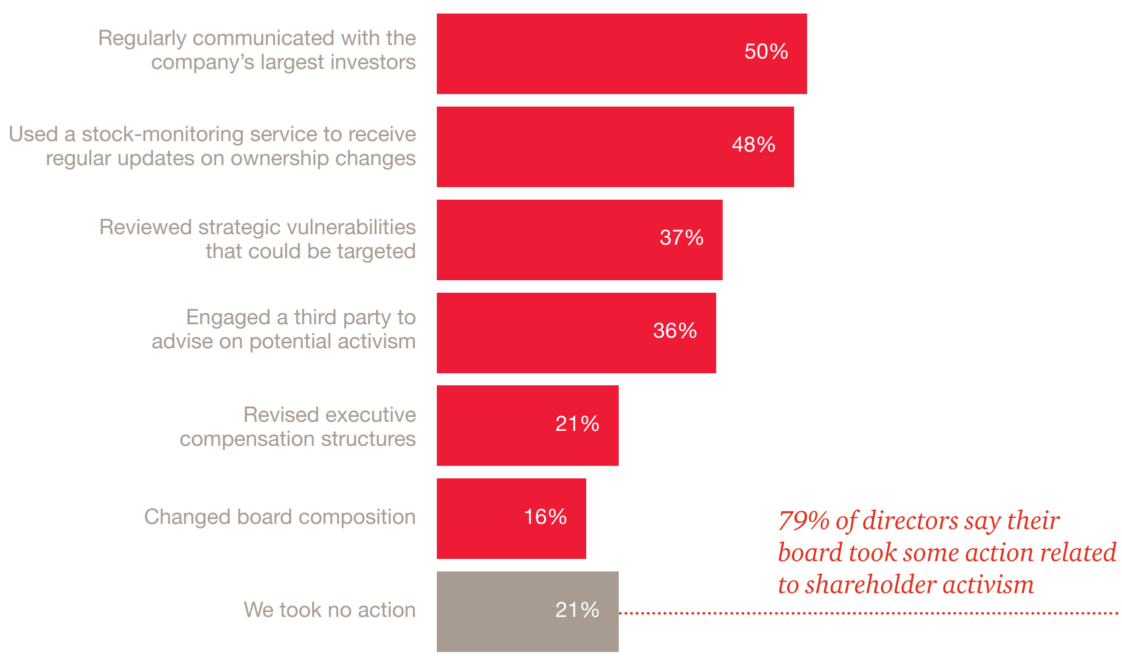
For more information, see our ***shareholder activism page*** and our recent report, ***Director-shareholder engagement: the new imperatives***.

Getting ahead of activism

With $173 billion now under management by activist investors[8] and 420 US activist campaigns last year,[9] it's not surprising that nearly four of five directors say their board took proactive steps to prepare for actual or potential activism. About half say their board regularly communicated with the companies' largest investors and used a stock-monitoring service to provide regular updates about changes to company ownership. Nearly four in ten say their board reviewed strategic vulnerabilities that could be targeted by activists and engaged a third party to advise the board on potential activism. A number of directors also say their board took action by revising executive compensation plans or changing board composition (21% and 16%, respectively).

> *"Assessing both your financial performance and your governance vulnerabilities is the best way to prepare for activism. Actively listening to shareholders should be a significant part of this effort."*
>
> **Paula Loop**
> Leader, PwC's Governance Insights Center

Over the past 12 months, has your board done any of the following regarding actual or potential shareholder activism?



Base: 793
Source: PwC, *2016 Annual Corporate Directors Survey*, October 2016.

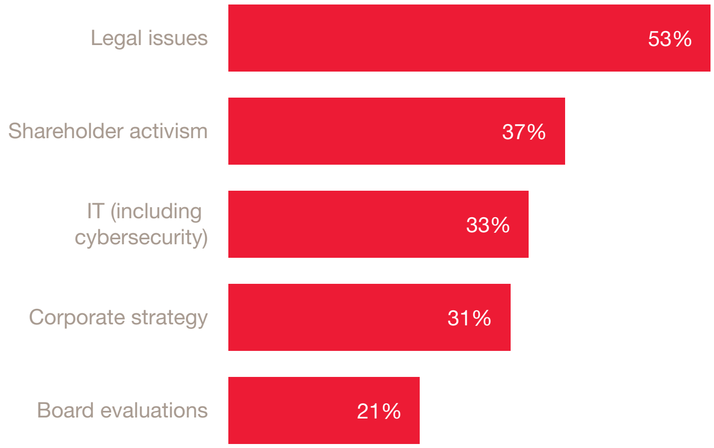
8 Activist Insight, *Activist Investing: An annual review of trends in shareholder activism*, January 2016.
9 FactSet with PwC analysis, May 2016.

Board priorities and practices

Knowing what you don't know

While boards are expected to oversee a significant number of areas, they cannot be experts in everything. In areas that they have less experience with, it's often more beneficial to seek third-party advice than it is to add a board member with deep, but potentially narrow expertise. Over the last 12 months, the majority of directors (53%) say their boards have engaged a third party, separately from management, to advise them on legal issues; nearly four in ten have done so regarding shareholder activism. And about one third of directors have used third parties to advise on corporate strategy and IT issues.

Over the past 12 months, has your board or its committees engaged a third party, separately from management, to advise on the following?

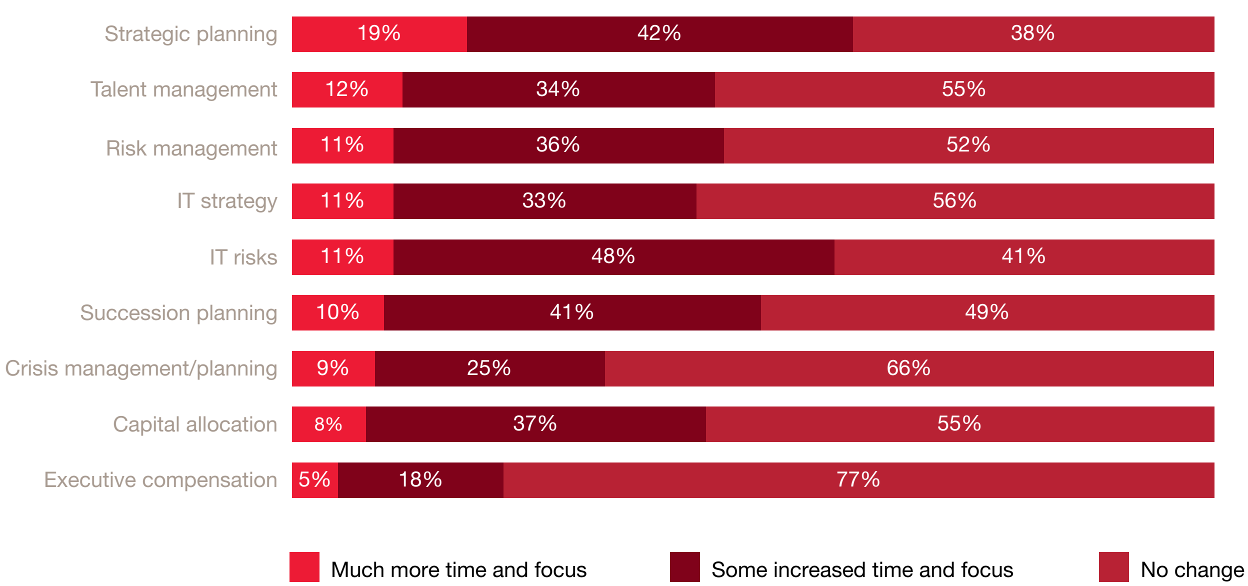


Base: 622
Source: PwC, *2016 Annual Corporate Directors Survey*, October 2016.

Where do directors want to spend more time?

Consistent with results from the last five years, strategy continues to be an area in which many directors want to spend more time; 61% want at least some additional boardroom time and focus on strategy, and about one in five want much more time and focus. Directors also want to give more time and attention to IT risks like cybersecurity and IT strategy; 59% want at least some additional time and focus on IT risks, and 44% want additional attention given to IT strategy. Directors are least likely to want to spend more time on executive compensation. This may be due to the extensive attention that compensation, and say-on-pay in particular, has received over the last several years.

Please indicate if you believe your board should change the amount of time it spends on the following:

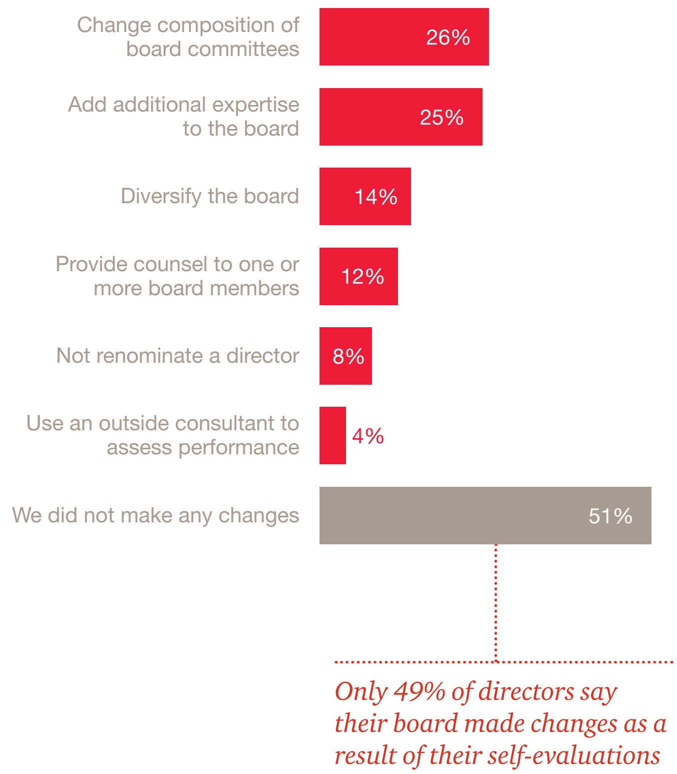


Base: 803–809
Source: PwC, *2016 Annual Corporate Directors Survey*, October 2016.

Sometimes it's hard to make changes

A robust board evaluation process can offer valuable insights into how the board is functioning and how individual directors are performing. The board can then use this process to identify directors who may be underperforming or whose skills may no longer match what the company needs. But, in order to be more than a 'check-the-box' exercise, boards need to take action on the results of their self-evaluations. However, only about half of directors (49%) say their board actually made changes as a result of their self-evaluations. Boards that did take action were most likely to have changed the composition of committees or added additional expertise. Considering that more than one in three directors believe someone on their board should be replaced (see page 7), it's noteworthy that only 8% of directors say they decided not to renominate a director as a result of their self-evaluation.

In response to the results of your last board/committee self-evaluation process, did your board/committee decide to do any of the following?



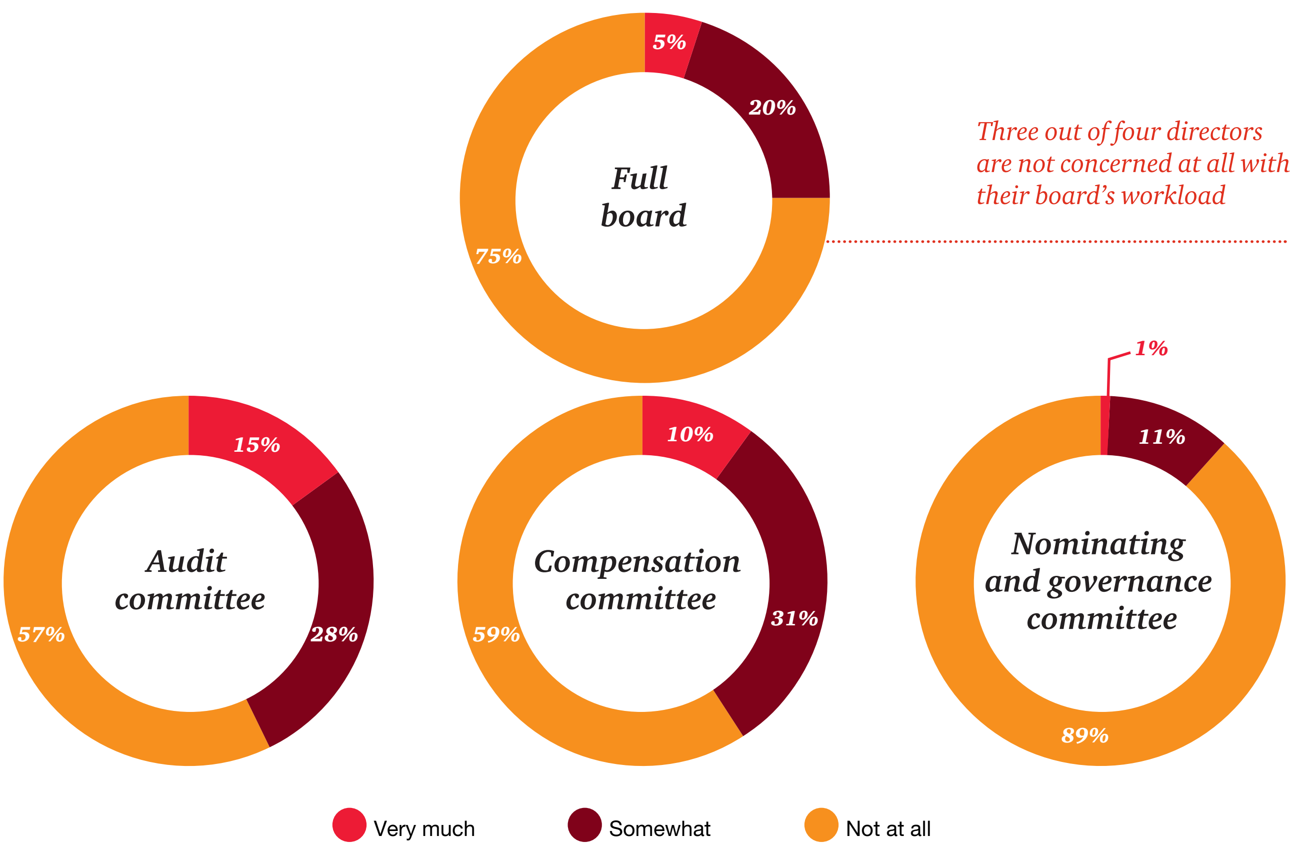
Base: 792
Source: PwC, *2016 Annual Corporate Directors Survey*, October 2016.

The workload is manageable

The average annual time commitment for public company directors last year was 248 hours.[10] And boards are increasingly being asked to expand their areas of oversight. But directors don't appear to be overwhelmed with the responsibilities of their roles. Surprisingly, only 5% are very much concerned with their board's workload.

Directors indicate relatively more concern with the workloads of their audit and compensation committees (43% and 41% express at least some concern, respectively). Despite the heavy investor focus on board composition, the shareholder activism climate, and a breakthrough year for proxy access, only about one in ten directors are at all concerned about the workload of their nominating and governance committee.

To what extent are you concerned with the workloads of the following:



Base: 794–798
Source: PwC, *2016 Annual Corporate Directors Survey*, October 2016.

10 NACD, *2015–2016 Public Company Governance Survey*, 2015.

Director engagement with IT

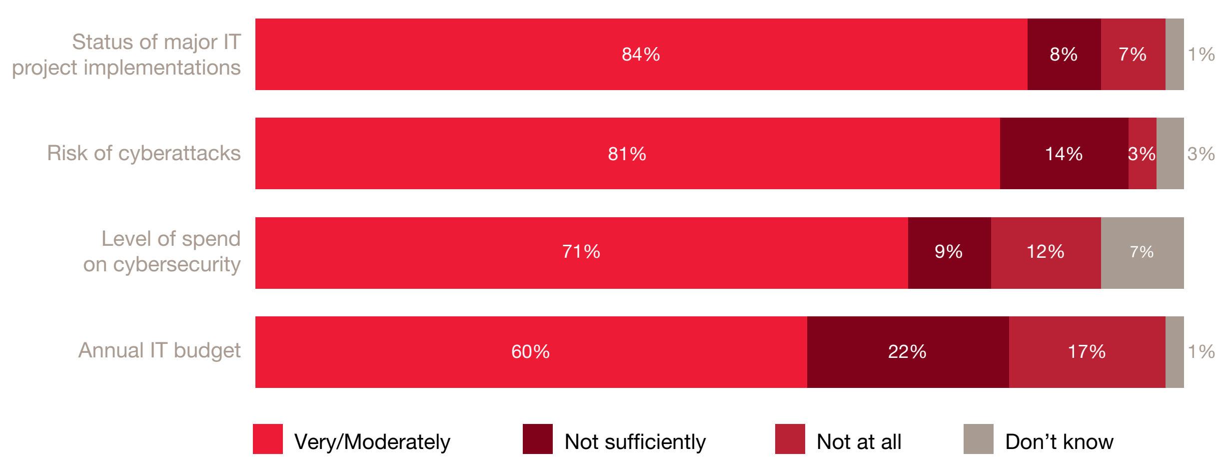
Directors continue to be engaged in understanding how IT issues impact their companies' long-term strategies. Eighty-four percent say they are at least moderately engaged in understanding the status of major IT implementations, and 81% of directors describe themselves as at least moderately engaged with overseeing the risk of cyberattacks. The company's annual IT budget and level of spend on cybersecurity are two other topics that generally receive robust director engagement; more than six in ten now describe themselves as at least moderately engaged in these areas.

Deeper insights

Directors at the largest companies are more engaged in overseeing cyber risks and the company's cybersecurity spend;

68% of directors at mega-sized companies say their board is very engaged in overseeing/understanding the risks of cyberattacks, compared to 32% of directors at smaller companies. And 62% of directors at mega-sized companies view their board as very engaged in overseeing/understanding their level of spend on cybersecurity, compared to only 7% of directors at smaller companies.

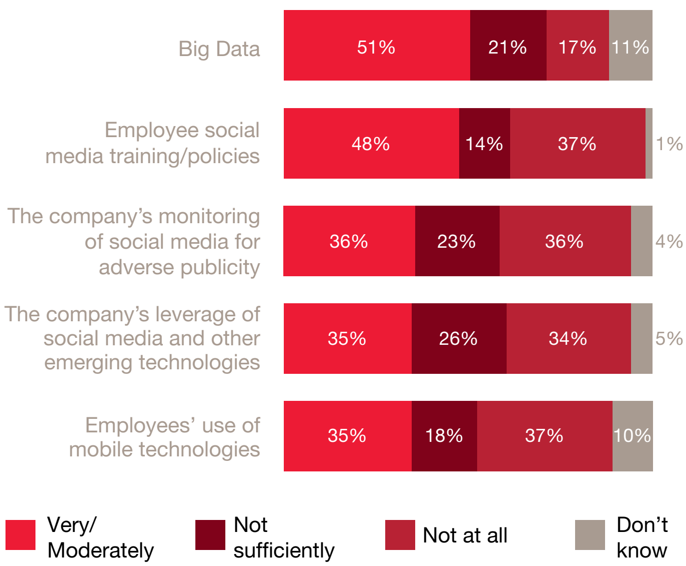
How engaged is your board or its committees with overseeing/understanding the following:



Base: 793–823
Source: PwC, *2016 Annual Corporate Directors Survey*, October 2016.

However, in more emerging IT areas, directors are less involved: about one-third say they are not at all engaged in overseeing of their company's employee social media training policies, their company's monitoring of social media for adverse publicity, how the company leverages social media and other emerging technologies, or employee use of mobile technologies.

How engaged is your board or its committees with overseeing/understanding the following:



Base: 793–822
Source: PwC, *2016 Annual Corporate Directors Survey*, October 2016.

PwC perspective
IT oversight for boards

Our research over the last five years indicates that many board members are uncomfortable with overseeing IT at their companies. Although many directors want to better comprehend the risks and opportunities related to IT, they sometimes don't have an adequate understanding of the subject to be truly effective in their oversight roles. In addition, boards often lack well-defined processes that satisfy their needs in this area. On the whole, this confluence of factors creates an 'IT confidence gap' for many board members.

What can the board do to bridge the 'IT confidence gap?' Structured frameworks for IT professionals and management already exist; however, they are not designed with the board's oversight role in mind. To fill this void, PwC has developed a guide, which introduces our IT Oversight Framework, to help boards figure out how to best oversee IT at their companies.

For many boards, cybersecurity has moved to the forefront of director concerns, and they may be myopically focused on this issue. However, we suggest boards take a step back and look at IT more broadly and in a holistic manner.

PwC's IT Oversight Framework is a process that:

- embraces IT oversight in a cohesive, comprehensive, and holistic manner;
- provides a structured approach for boards to help with their oversight responsibilities;
- offers flexibility for customization based on the company's specific circumstances;
- includes leading oversight practices to facilitate discussions with the chief information officer (CIO), company management, or outside consultants; and
- may help identify IT issues that may not currently be on management's or the board's radar.

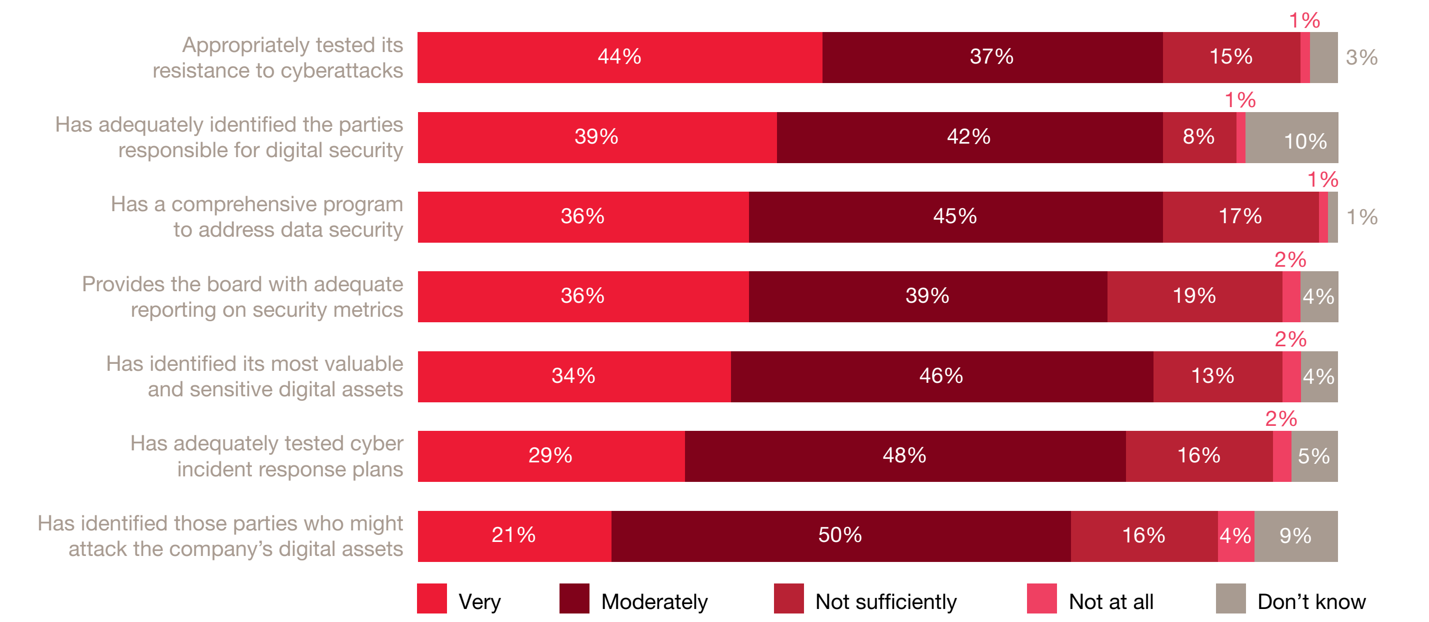
For additional information on overseeing IT, see our user-friendly comprehensive guide ***Directors and IT***.

Director confidence about cybersecurity

Cybersecurity concerns continue to dominate the news headlines, and it is an issue that many boards are focused on. According to recent research, the identities of over 429 million people were exposed in cyber breaches last year.[11] Despite this, director confidence about cybersecurity is high; more than eight in ten are at least moderately confident that their company has a comprehensive program in place to address data security. The same percentage (81%) are at least moderately comfortable that their companies have adequately identified the parties responsible for digital security, and that their company has appropriately tested its resistance to cyberattacks.

However, about one in five directors say their management teams don't sufficiently, or at all, provide the board with adequate security metrics. Similarly, 20% of directors don't feel their company has sufficiently, or at all, identified those parties who might attack their company's digital assets.

How comfortable are you that your company:



Base: 820–821
Source: PwC, *2016 Annual Corporate Directors Survey*, October 2016.

Deeper insights

Directors at the largest companies are more comfortable that their company has adequately tested its resistance to cyberattacks;

***63%** of directors at mega-sized companies are very comfortable, compared to only 27% of directors at smaller companies.*

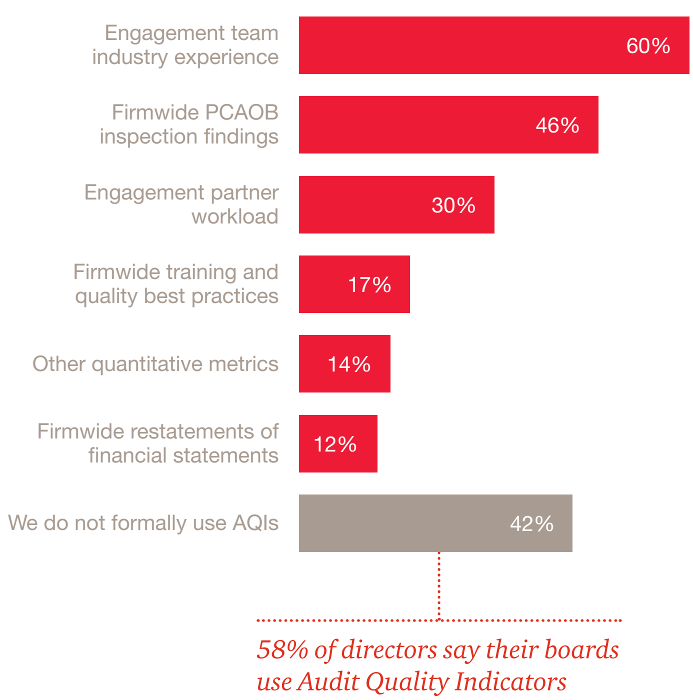
11 Symantec, *Internet Security Threat Report,* April 2016.

Assessing the quality of the audit

Audit Quality Indicators (AQIs) refer to various quantitative measures used to enhance the dialogue regarding the quality of audits performed by the external auditors. AQIs can be tailored for a company's specific needs and can be a useful tool for an audit committee in its oversight of the external auditor.

A majority of audit committees use AQIs to evaluate their company's external auditors. The most common of these are engagement team industry experience and firm-wide Public Company Accounting Oversight Board (PCAOB) findings (used by 60% and 46% of audit committees, respectively). Audit committees also use metrics, such as engagement partner workload and firmwide training, and quality best practices, to lesser degrees.

Which quantitative metrics does the audit committee use in its oversight of the external auditor to assess the quality of the audit—commonly referred to as 'Audit Quality Indicators' or AQIs?



Base: 695
Source: PwC, *2016 Annual Corporate Directors Survey*, October 2016.

PwC perspective
Audit Quality Indicators (AQIs)

AQIs can be useful for an audit committee in assessing the quality of the external audit as part of its oversight role. Potential AQIs have been developed by both the PCAOB in its concept release and the Center for Audit Quality (CAQ) in the *CAQ Approach to Audit Quality Indicators* paper.

Over half of the directors surveyed indicated that the audit committee formally uses AQIs in its oversight of the external auditor. Our experience is that the formal use of AQIs is less common than the results of our survey suggest. While quantitative metrics are often used for specific areas, as noted in the survey results, the more formal use of a selected set of AQIs by audit committees used consistently is growing but continues to be a relatively new concept.

For additional information on AQIs, see our ***Point of view: Audit quality–Can it be measured?***

Deeper insights

Audit committees at smaller companies are much more inclined to use AQIs (63%) than at mega-sized companies (39%).

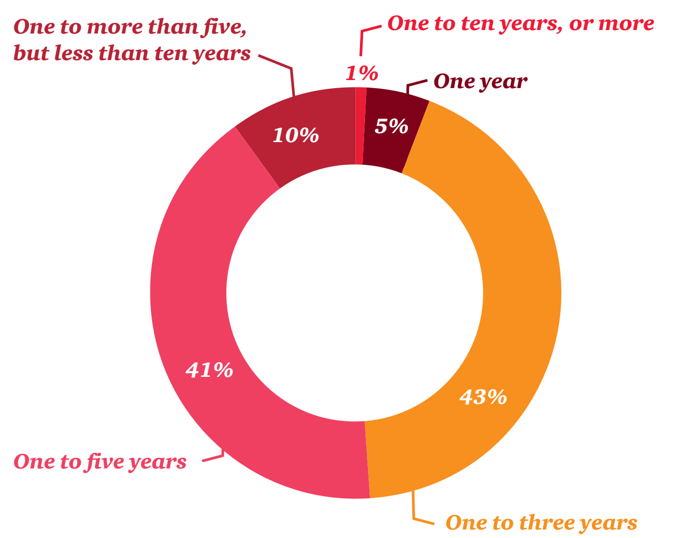
Strategy and risk oversight

Strategic time horizons

Right before the 2016 proxy season, BlackRock's CEO Larry Fink sent a letter to the 500 largest companies in which BlackRock invests expressing concern about an excessive focus on short-termism. He asked that every CEO lay out for shareholders each year a strategic framework for long-term value creation. He stated that *"because boards have a critical role to play in strategic planning…CEOs should explicitly affirm that their boards have reviewed those plans."*[12]

Strategic oversight is clearly one of the board's primary responsibilities. And a development in this area is the use of longer-term horizons for reviews of strategic plans; 52% of directors now say their company's strategic time horizon is one to five years or greater, compared to 48% in 2011. Only 43% of directors now say they use a one to three year time horizon in evaluating strategy, compared to 52% five years ago. This shift may indicate that boards are responding to investors' pressure that they address strategy from a long-term shareholder value perspective.

When your board is discussing the company's strategy, what time horizon is primarily used?



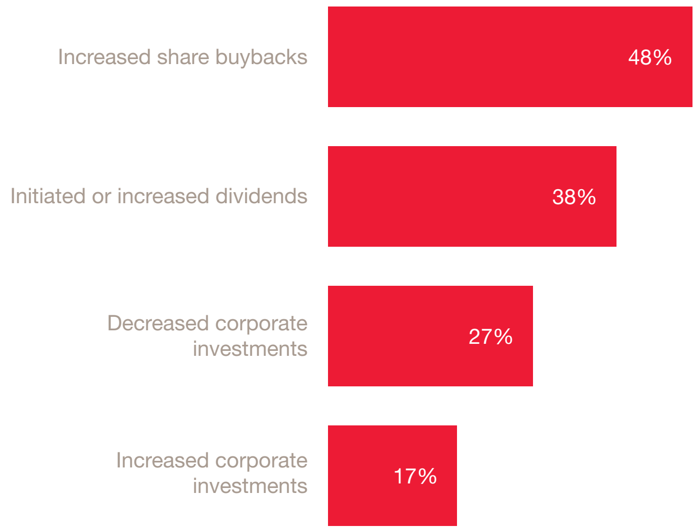
Base: 795
Source: PwC, *2016 Annual Corporate Directors Survey*, October 2016.

12 BlackRock, Larry Fink's 2016 Corporate Governance Letter to CEOs, February 2016.

Investors driving capital allocation strategies

To what extent should a company's shareholders drive its capital allocation strategy—particularly its use of cash? While the increase in shareholder activism has put this question up for debate, investors are increasingly feeling empowered to influence how companies use their resources, and are driving specific actions. Nearly half of directors say their company increased share buybacks as a result of actual or potential investor demands, while another 38% say the company initiated or increased dividends. These actions speak to the challenges that management and the board face in balancing execution of the company's long-term strategy with what some investors may want the company to pursue in the short term.

Has your company made any of the following changes to its capital allocation strategy to be responsive to actual or potential investor demands?



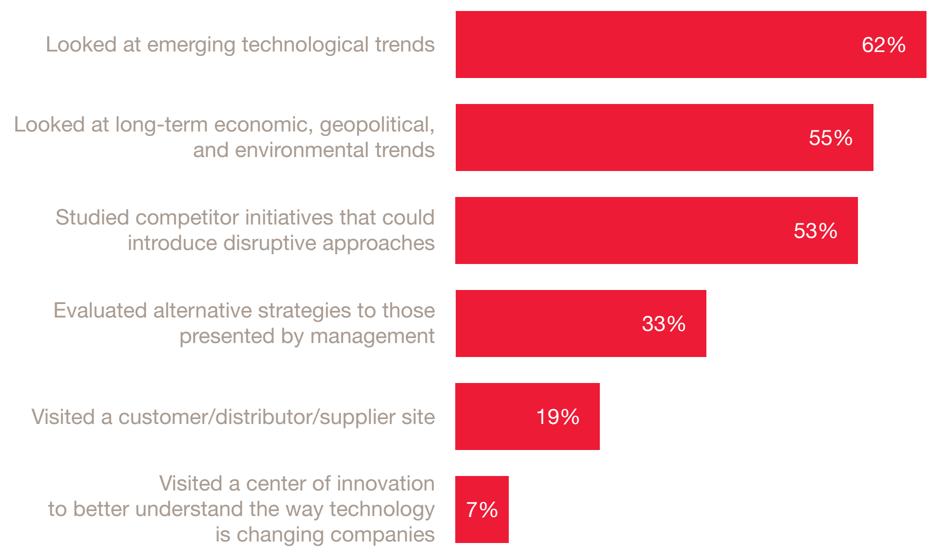
Base: 548
Source: PwC, *2016 Annual Corporate Directors Survey*, October 2016.

Board approaches to strategy

When it comes to reviewing company strategy, there are a number of practices that boards frequently employ. A majority of directors say their board looks at emerging technological trends (62%) and long-term economic, geopolitical, and environmental trends (55%). A similar proportion (53%) study competitor initiatives that could introduce disruptive approaches and one third evaluate alternative strategies to those presented by management.

Directors are less likely to participate in visits to customer, distributor, or supplier sites, or to centers of technological innovation; less than one in five say their board has done so to better understand their company's business or the impact of new technologies.

Which of the following has your board done in the past 12 months regarding strategy?

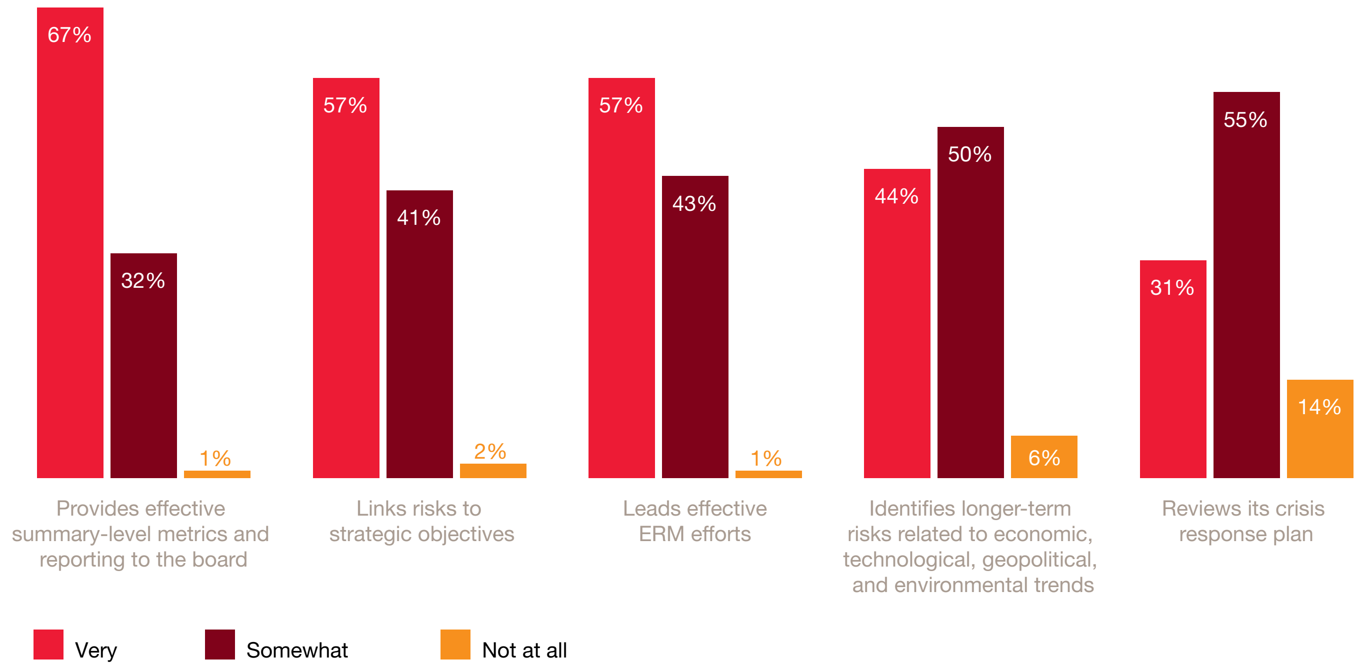


Base: 757
Source: PwC, *2016 Annual Corporate Directors Survey*, October 2016.

How good are we at risk management?

Directors generally believe that their management teams have a good handle on risk. About two-thirds say management is very good at providing effective summary-level metrics and reporting to the board. Nearly six in ten think management does an excellent job of linking risks to strategic objectives and leading effective enterprise risk management (ERM) efforts. However, directors voiced some concern about management's review of the company's crisis response plan; less than one-third believe management does this very well and 14% say management doesn't do it well at all.

In your opinion, how well do you believe management performs the following activities:



Base: 796–797
Source: PwC, *2016 Annual Corporate Directors Survey*, October 2016.

Deeper insights

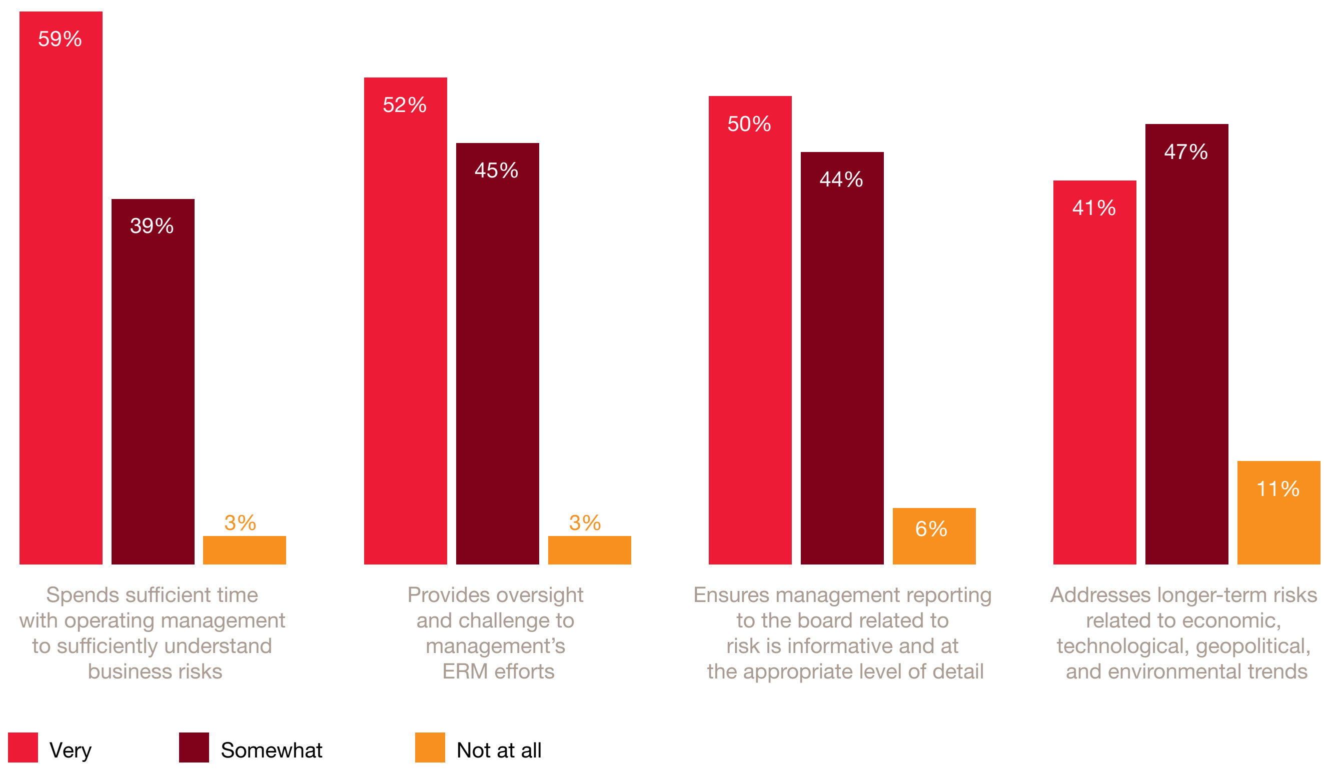
Directors at the largest companies are more likely to think management leads effective ERM efforts and identifies longer-term risks;

73% of directors at mega-sized companies *think management leads effective ERM efforts very well, compared to* ***33% of directors at smaller companies.***

58% of directors at mega-sized companies *think their management teams identify longer-term risks related to economic, geopolitical, and environmental trends very well, compared to* ***24% of directors at smaller companies.***

Directors have a high degree of confidence in their board's ability to oversee the risks facing their companies; more than half believe that their board performs very well when it comes to spending sufficient time with management to understand business risks and providing oversight and challenge to management's ERM efforts. A similar number say their board does an excellent job at ensuring management provides risk reporting that's informative and at the appropriate level of detail. While directors are confident in their discussions with management on this topic, they are less comfortable discussing risk oversight with investors as compared to other topics (see page 12).

In your opinion, how well do you believe your board performs the following activities:



Base: 795–797
Source: PwC, *2016 Annual Corporate Directors Survey*, October 2016.

Deeper insights

Directors with greater tenure are more likely to think their board provides very effective oversight and challenge to management's ERM efforts;

58% *of directors with tenure of more than ten years believe their board performs very well, compared to 19% of directors who have served on their board for two years or less.*

Do risk committees work?

Where risk oversight should reside at the board level is a hot topic of debate. While a majority of boards continue to assign risk oversight responsibilities to the audit committee, a growing number have made risk oversight a full-board function. One quarter of directors stated that their board has a separate committee tasked with risk oversight. Of those boards that do have risk committees, all directors surveyed believe they are at least somewhat effective. However, more than half of directors (55%) say their board doesn't have a risk committee and don't believe one is necessary. On the other hand, 14% of directors are either discussing establishing a risk committee or think their boards should have one.

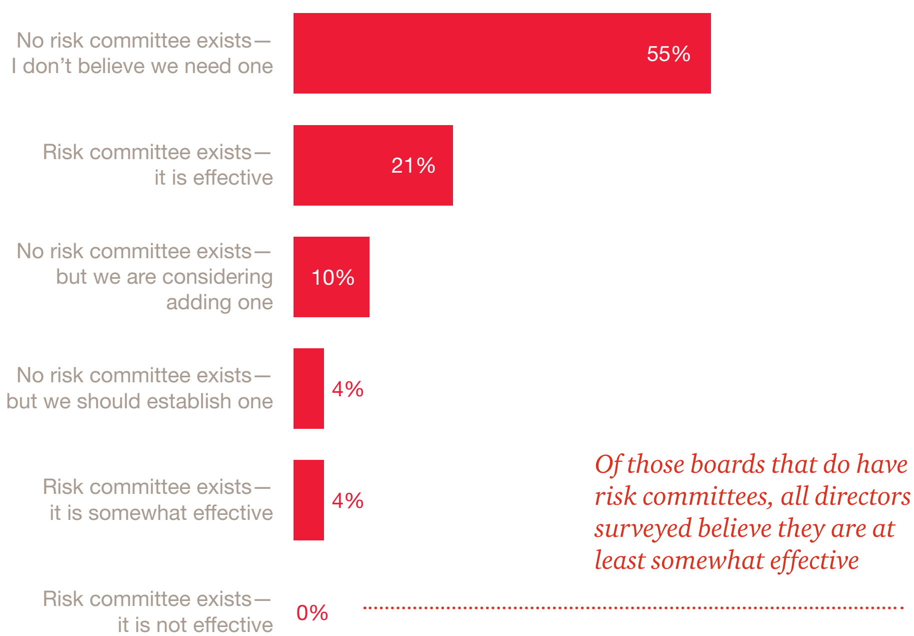
Deeper insights

Risk committees are far more prevalent in the financial services sector;

73%

of financial services company directors say their board has a separate risk committee, compared to 17% of directors from companies outside of financial services. This could be, in part, because many financial services companies are required by the Dodd-Frank Act to have risk committees.

Which of the following represents your current board practice and your views with respect to separate risk committees?

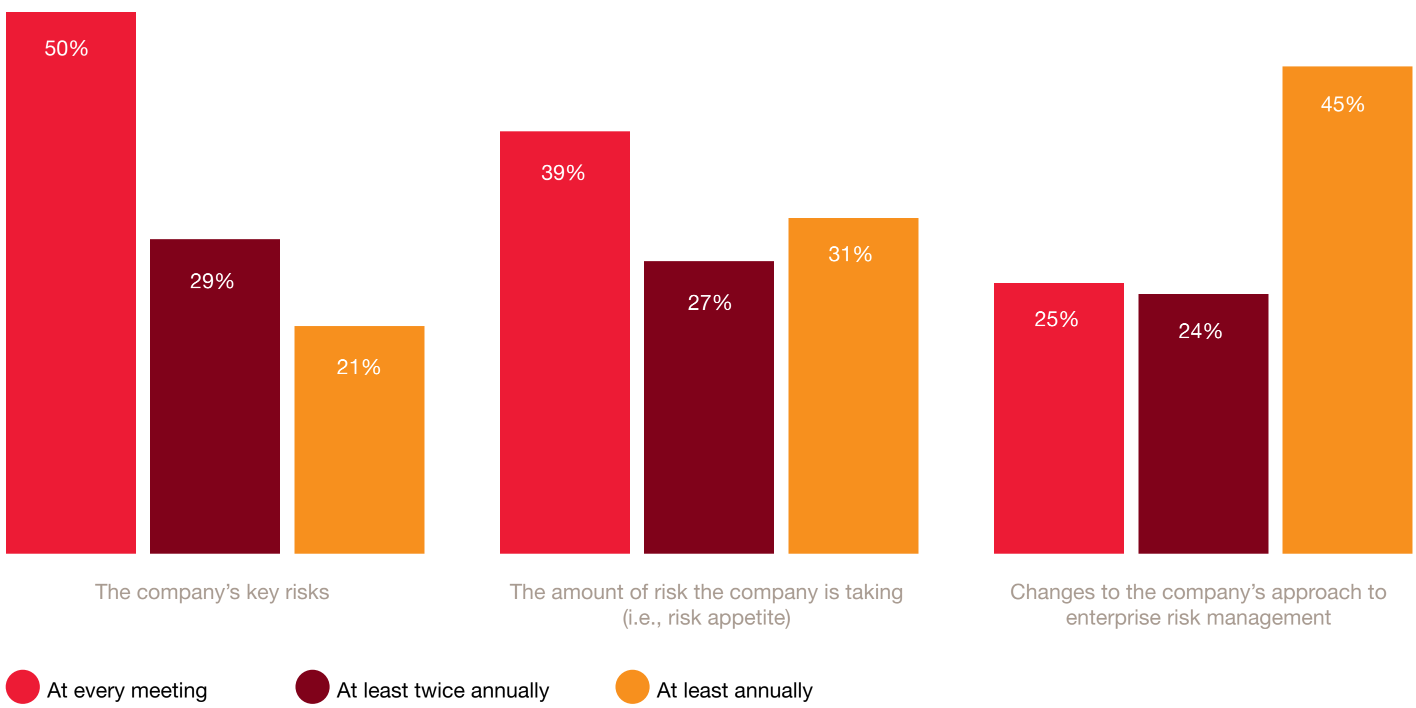


Base: 759
Source: PwC, *2016 Annual Corporate Directors Survey*, October 2016.

Staying updated on risk

Getting information on risk with the right frequency is a critical prerequisite for effective risk oversight at the board level. Only then are boards in a position to effectively contribute to company strategy, recognize potential disruptors in the marketplace, and ask the right questions of their management teams about their risk mitigation efforts. However, practices regarding the frequency of risk updates from management are diverse; half of directors receive updates on key risks at every board meeting, with 29% receiving these updates at least biannually and 21% at least annually. Management updates on the amount of risk the company is taking and changes to the company's approach to enterprise risk management are less frequent; 39% and 25% of directors say they receive such updates at every board meeting, respectively.

How often does your board get updates and reports from management on:



0–1% of directors responded 'Don't know';
1–6% of directors responded 'Never'

Base: 793–794
Source: PwC, *2016 Annual Corporate Directors Survey*, October 2016.

The toughest risks to oversee

While boards are tasked with overseeing risk in a number of different areas, a few were identified as particularly challenging. Directors are most likely to rate strategic/disruptive risk, IT risk, competitive risk, US compliance/regulatory risk, and operational risk as among the most challenging areas when it comes to oversight. They are less likely to view third-party risk, social and environmental risk, and fraud risk as providing much challenge.

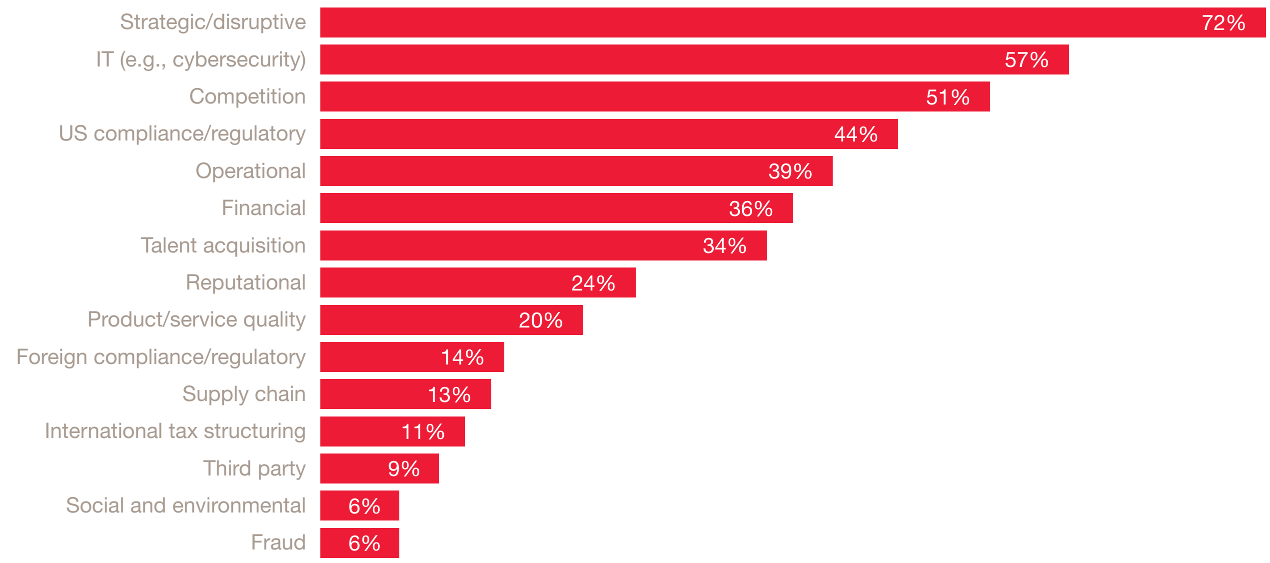
PwC perspective Third-party risk

Today's companies are increasingly integrated with their suppliers, distributors, and other providers. Consider that third parties provide so much leverage to today's companies that as a group, 89 companies in the Fortune 500 average over 100,000 suppliers each—that's over 9 million total direct supplier relationships.

With these relationships comes risk; companies are exposed to risk related to the actions of their third-party providers. In fact, according to our analysis performed in 2014, over the prior five years, intermediaries were involved in three out of four cases of bribery of public officials. Also, every bribery case prosecuted by the Department of Justice in 2012 involved a third party.

For tips on overseeing third-party risks, see our ***Audit Committee Excellence Series: Oversight of third-party risks***.

Which of the following risks pose the greatest oversight challenges to your board?



Base: 795
Source: PwC, *2016 Annual Corporate Directors Survey*, October 2016.

Executive compensation and CEO succession

Who's driving executive pay?

Compensation consultants continue to have the strongest influence on director decisions about executive compensation. Fifty-four percent of directors describe them as very influential—up 17 percentage points from 2013. Proxy advisory firms also saw their influence increase over the last several years; 59% of directors now describe them as at least moderately influential, compared to 49% three years ago. But CEO pressure declined as an influence; only 34% of directors now describe it as at least moderately influential (compared to 45% who said so in 2013).

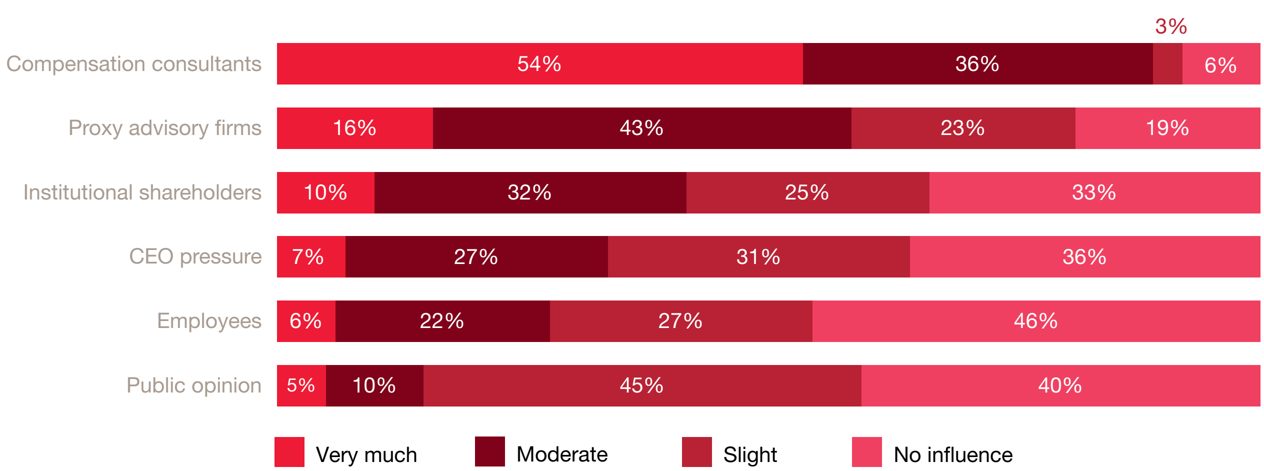
Deeper insights

Directors at smaller companies think compensation consultants have a greater influence on executive compensation;

63%

of directors at smaller companies think compensation consultants are very influential on their board's decisions about executive compensation, compared to 39% of directors at mega-sized companies.

Rate the level of influence that the following have over your board's decisions on executive compensation:

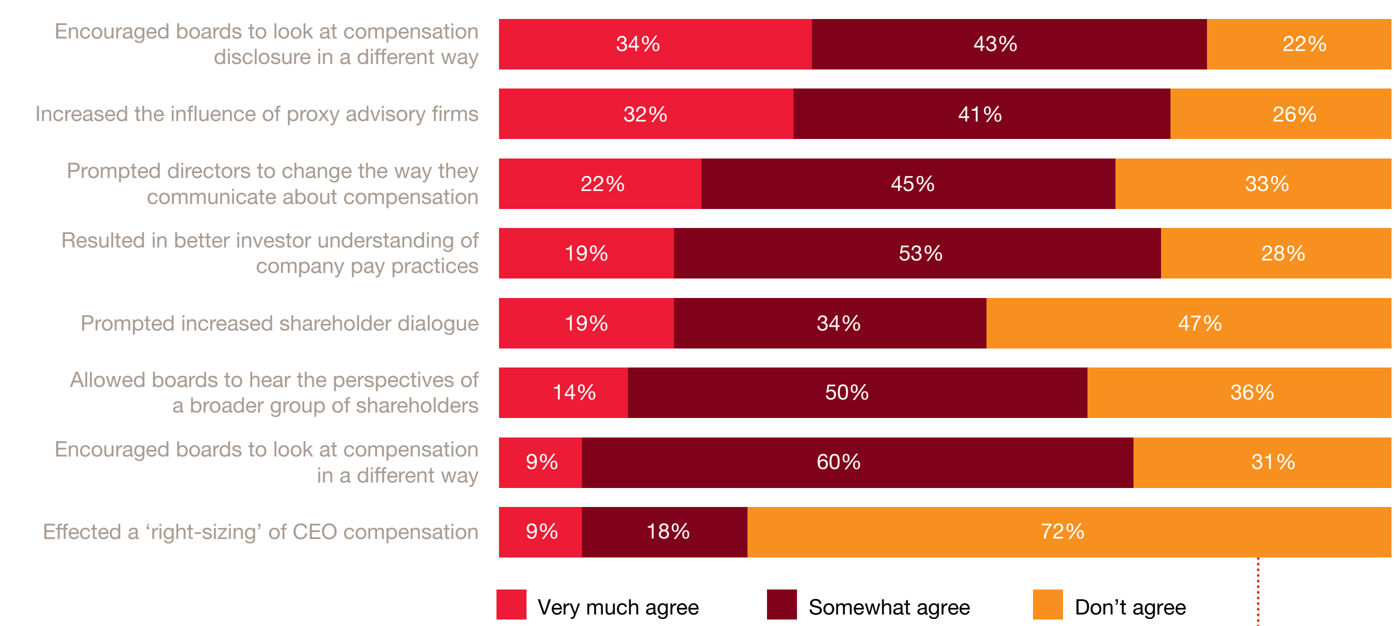


Base: 792–819
Source: PwC, *2016 Annual Corporate Directors Survey*, October 2016.

The real impact of say-on-pay

Shareholders continued to vote in favor of companies' overall executive compensation at high levels during the 2016 proxy season—with average say-on-pay support of 89%.[13] But what has the real impact of say-on-pay voting been since its inception in 2011? Seventy-seven percent of directors at least somewhat agree that say-on-pay voting has caused their board to look at compensation disclosure in a different way; 73% believe it increased the influence of proxy advisory firms. A similar number at least somewhat agree that say-on-pay has resulted in better investor understanding of company pay practices, and about two-thirds say it prompted their board to change the way it communicates about compensation. Yet say-on-pay is not generally seen as having reduced pay; 72% of directors don't think it has effected a 'right-sizing' of CEO compensation.

What is your assessment of the cumulative impact of say-on-pay voting?



Say-on-pay is not generally seen as having reduced pay; 72% of directors don't believe it has effected a 'right-sizing' of CEO compensation

Base: 752–808
Source: PwC, *2016 Annual Corporate Directors Survey*, October 2016.

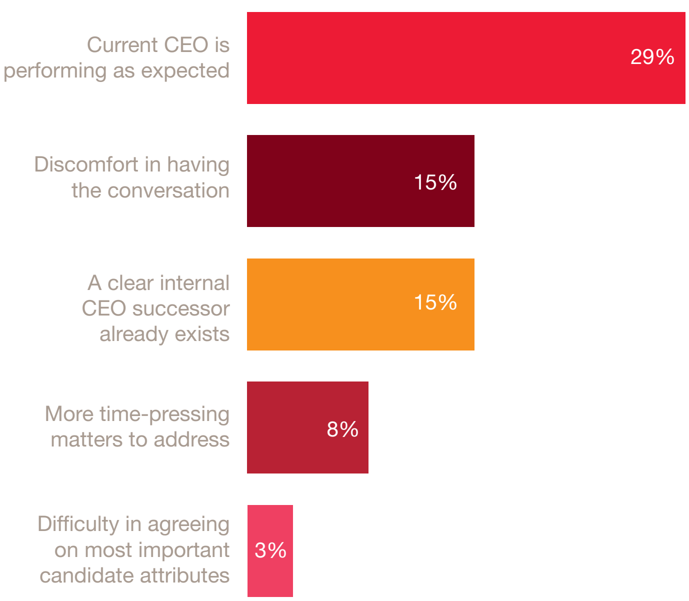
13 PwC + Broadridge, *ProxyPulse 2016 Proxy Season Review,* September 2016.

Challenges to CEO succession planning

Ensuring that the company has a robust CEO succession plan is a critical board responsibility. But there are a number of factors that may be preventing some boards from focusing on CEO succession to the extent they would like; 51% of directors say they want to spend more time on succession planning (see page 17).

Directors say that the single greatest challenge to more timely and effective CEO succession planning is that the current CEO is performing as expected (29%). However, the current CEO's performance should not factor into the board's need to have a robust succession plan, as emergency succession events may occur, and boards and companies need to be prepared for them. An equal number of directors (15%) each say the greatest challenge to more timely and effective CEO succession planning is discomfort in having the conversation or that a clear internal successor already exists.

What is the single greatest challenge to more timely and effective CEO succession planning?



29% of directors responded 'None of the above'

Base: 764
Source: PwC, *2016 Annual Corporate Directors Survey*, October 2016.

PwC perspective
CEO succession planning

With a 16.6% CEO turnover rate at the world's 2,500 largest companies in 2015—the highest in the past 16 years—CEO succession planning is getting much more focus from boards. The decision-making process depends on many variables, but data from a recent study from Strategy&, PwC's strategy consulting team, shows that the background of the directors who are making the decision have just as much influence on the process as the candidates themselves. And as boards continue to focus on this topic, they need to be aware of biases they may bring to the table; for example, a board made up of individuals with diverse backgrounds might arrive at a different decision than a more homogeneous board.

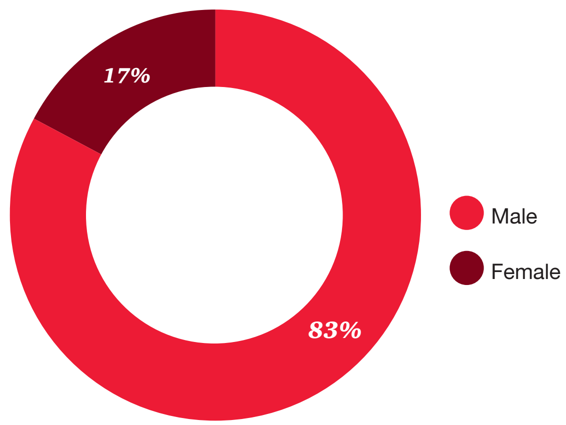
Low-performing companies tend to choose external candidates because they can bring fresh ideas or skills that the current management team may lack. High-performing companies may tend to go with a less disruptive plan that would more likely focus on an internal candidate—if available. Interestingly, when the board chair and other board members were insiders, the board was more likely to choose an internal candidate. In other words, board members seem more comfortable mirroring a similar path than deviating from it. Companies that have historically chosen internal CEO candidates were more likely to continue to do so. Similarly, those boards that selected an external candidate once were more likely to do so again.

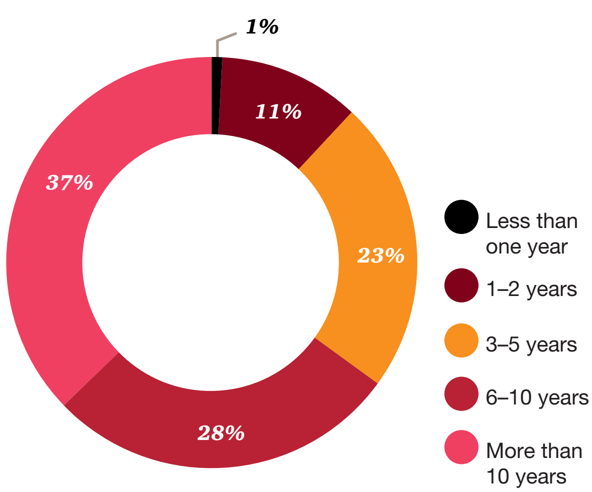
Given the fast pace of change that multinational companies are experiencing today, plus the impacts of shareholder activism and talent shortages, boards should be cultivating both internal and external candidates in their CEO succession plans—regardless of the performance of the current CEO.

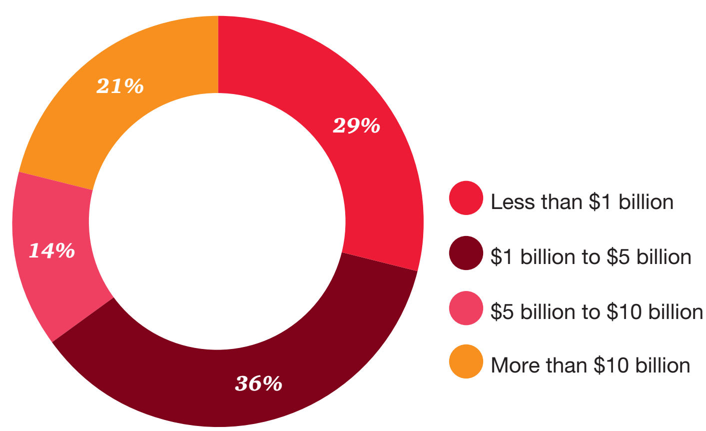
For more information, see Strategy&'s ***2015 CEO Sucess study***.

Demographics of survey participants

Demographics







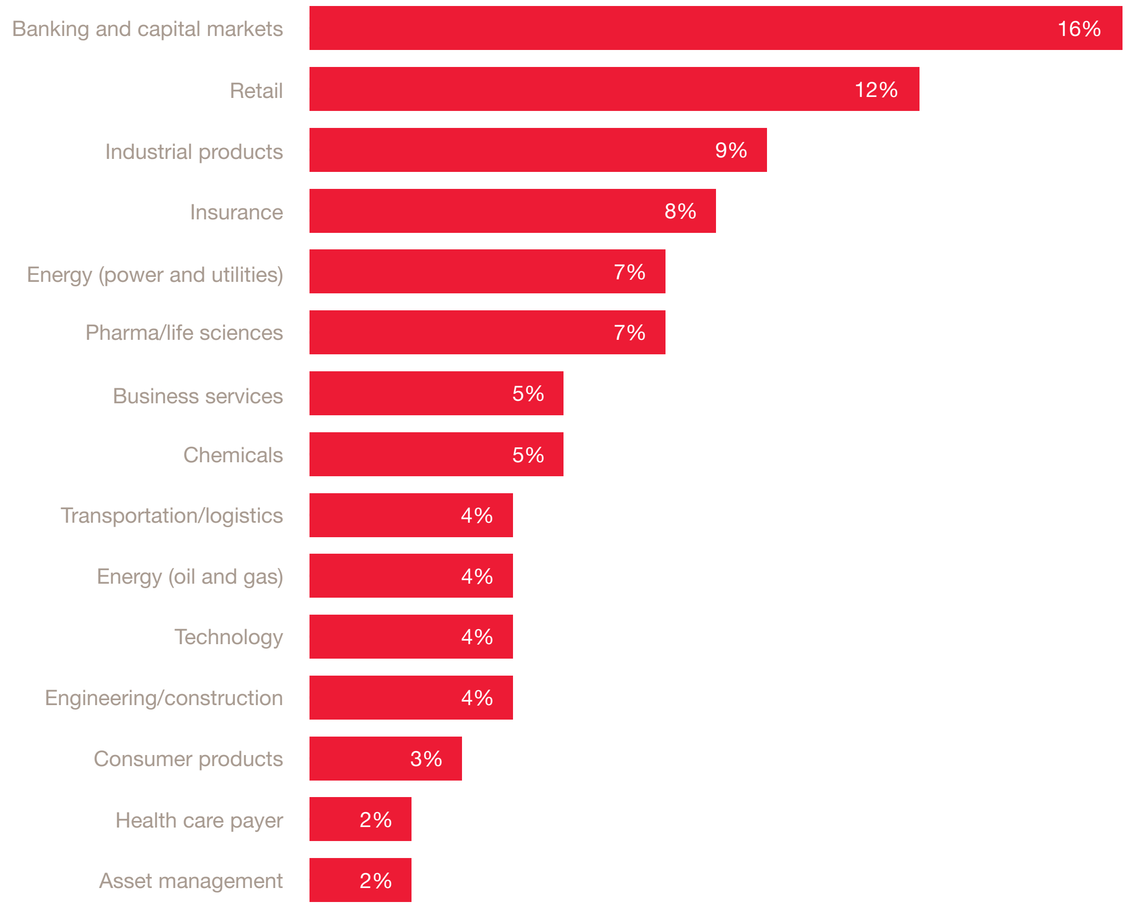
Base: 812–817
Source: PwC, *2016 Annual Corporate Directors Survey*, October 2016.

Note: The company sizes referenced in the report reflect the following annual revenues:

Mega-sized companies	Large companies	Mid-sized companies	Smaller companies
More than $10 billion	$5 billion to $10 billion	$1 billion to $5 billion	Less than $1 billion

Demographics

Which of the following best describes the company?



Each of the following industries comprised approximately 1% or less of survey respondents:
Health care provider, Software/internet solutions, Automotive, Mining, Semiconductor, Government contracting, Communications, Hospitality/leisure, Agra business, Forest, paper and packaging, Entertainment/media.

Base: 812
Source: PwC, *2016 Annual Corporate Directors Survey*, October 2016.

How PwC can help

To have a deeper discussion about how this topic might impact your business, please contact your engagement partner or a member of PwC's Governance Insights Center.

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