KPMG

Directors Quarterly

Insights from the Board Leadership Center

April 2017

Growing demand

As economic indicators go, the positive signs are all there: consumer demand, manufacturing output, business spending, jobs growth, and productivity. Forecasts of solid growth in the U.S. and Asia, a surer-footed Europe, and the continuing recovery of emerging markets put the world's rich and developing economies on track to grow together for the first time since 2010. The green shoots and deeper roots that economists see certainly bode well for 2017. But economic forecasts can turn quickly (over-tightening by the Fed, populist wins in Europe, conflicts and geopolitical tensions, etc.), and the way forward won't be clear cut, particularly for U.S. companies. A higher interest-rate environment and stronger U.S. dollar, potential changes to trade agreements and tariffs, corporate tax reform and repatriation issues, and an uncertain regulatory and fiscal landscape add layers of complexity to an already complex operating environment. The board's role in testing core assumptions—about the company's strategy and risk, customer expectations and competitive position, the business model itself—has always been important; now it's imperative.

Global demand is also growing on another front, with expectations mounting for greater corporate leadership on environmental, social, and governance (ESG) issues. As highlighted in this edition of *Directors Quarterly*, investors are sharpening their focus on how companies and boards are addressing ESG issues—from climate risks to board diversity and effectiveness—and the implications for long-term performance.

This quarter, we also share insights from our recent annual conference on key governance priorities in 2017—from the corporation's role in society and the new mindset in cybersecurity to shareholder engagement, crisis readiness, and financial reporting challenges; we look at blockchain technology from a board perspective; and we highlight financial reporting and auditing developments that audit committees should have on their radar in the months ahead.

We hope you find *Directors Quarterly* helpful in navigating the growth opportunities and governance challenges ahead.

Dennis T. Whalen
Leader
KPMG Board Leadership Center

Governance challenges and priorities driving the 2017 agenda

Risk-scenario planning, corporate agility, and a long-term perspective are high on the agenda as companies and their boards navigate significant uncertainty and heightened expectations for responsible growth and long-term performance.

Audit committee members from around the world joined KPMG business leaders at the 2017 Audit Committee Issues Conference on January 9–10 to discuss the governance challenges facing boards in the year ahead. Keynote speakers and panel members discussed a range of issues, including the shifting geopolitical and economic landscape; the increasing focus on board composition; the evolving role of the corporation in society; developments in cybersecurity; and the era of shared governance. Breakout sessions focused on a range of issues that are top of mind for audit committees, including key response and shareholder engagement. Attendees also participated in small group peer-exchange conversations to discuss how their audit committees are addressing these and other issues that are at the top of their agendas today.

"For boards and audit committees, focused yet flexible agendas—exercising judgment about what does and does not belong on the agenda and when to take deep dives—will be critical," said Jose R. Rodriguez, partner in charge and executive director of KPMG's Audit Committee Institute.

continued on pg 2

continued from pg 1

Kicking off the event, Lynne Doughtie, KPMG's chairman and CEO, emphasized the importance of innovation as the key to staying competitive in a rapidly changing marketplace. In an era in which new technologies and digital transformation are disrupting business models, innovation—and the speed of innovation—is critical and will be an essential element for growth for all companies, she noted. Doughtie introduced Pulitzer Prize-winning *Wall Street Journal* columnist and author Peggy Noonan, who offered her perspectives on the potential impact of the 2016 U.S. elections. Noonan observed that the unexpected outcome caught nearly everyone by surprise and left business leaders scrambling to understand the impact of the new administration's policies on their corporate strategies. "We are in unchartered waters," said Noonan. "The tectonic plates are moving in America, and they aren't going to stop anytime soon."

Conference takeaways at a glance

It is no longer business as usual. The Trump administration's "America first" approach is dramatically shifting the geopolitical and economic landscape.

Higher expectations for board performance have made board composition a key area of focus. Achieving and maintaining a high-performing board requires continuous improvement of overall board composition, individual director skills, and board processes.

The role of the corporation in society is now on the agendas of leading boards. Corporations are forging a tighter connection between "social capital" and bottom-line performance.

A new paradigm of corporate governance is here. Shareholder engagement is essential, and a long-term perspective on corporate performance is expected.

The boardroom discussion about cyber risk is changing. Boards are helping to elevate the cyber-risk mindset to an enterprise level to manage the potential operational, reputational, and strategic impacts of a major breach.

The shifting geopolitical and economic landscape

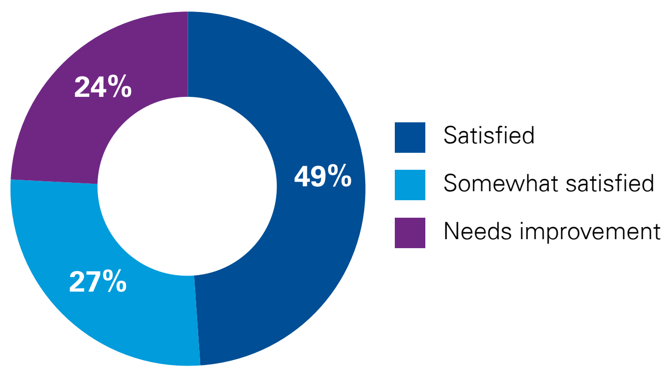
The U.S. election, Brexit, a slowing China, rising nationalism in Russia and Turkey, ongoing conflicts in the Middle East and North Africa, and a G-Zero world are among the forces reshaping the geopolitical landscape. Ian Bremmer, Eurasia Group founder and president, offered his outlook on the top geopolitical risks that ought to be on board agendas.

In Bremmer's view, the geopolitical risk environment in 2017 is the most volatile since World War II, marked by the absence of a global leader and weaker central governments. "The risks are serious, and there are many uncertainties," Bremmer said.

One of the greatest uncertainties is what President Donald Trump's approach means for U.S. foreign policy—and in particular, relationships with China, Russia, and Mexico.

While the administration's "America first" approach poses huge risks, Bremmer noted that it also provides some opportunity for positive change. With a Republican House and Senate, there is a greater opportunity for legislation—in the form of corporate tax reform, regulatory rollback, and infrastructure spending—that can "move the needle" and boost growth. Trump's approach "is transactional," said Bremmer, who expects to see more bilateral trade agreements. It is likely that the trend of globalization could be replaced by a more fragmented global market.

How satisfied are you with the quality of discussions your board is having with management regarding the impact of geopolitical risk on the company's operations and strategy?



Source: KPMG Audit Committee Issues Conference survey

Discussing the economic outlook, KPMG chief economist Constance Hunter said that, while the U.S. economy is on better footing today, there are a number of demographic headwinds—including low productivity growth and slowing population growth—that will make it difficult for the new administration to achieve its goal of 3 to 4 percent GDP growth. And there may be other headwinds, including the possibility of inflation and higher interest rates, a strong dollar, and new trade policies.

While a more business-friendly regulatory environment and tax policies have the potential to boost GDP, Hunter warned, "The transition period [to any new policies] will not be smooth." Of course, the wildcard in the economic forecast is business sentiment. "The forecasting model doesn't factor in those animal spirits," she said.

continued on pg 3

continued from pg 2

What's front-and-center for audit committees today?

Most conference attendees participated in small-group peer exchanges, providing insights on risk oversight, cybersecurity, corporate culture, and other issues that are top of mind for audit committees (and boards) today. Here are just a few of the insights we heard:

Risk oversight
"We still rely on the three lines of defense—compliance, risk management, and internal audit. But we've shifted the emphasis to the first line—compliance. You can't just expect quality and integrity at the end of the process. You have to get it right the first time, before it comes downstream."

Cybersecurity
"I think it's finally sunk in that we simply can't wall off the company from cyber risk. It's now a matter of internal awareness, mindset, and readiness for a breach. I see cyber discussions generally shifting from prevention toward detection and containment."

Corporate culture
"For us, it's all about spotting yellow flags and warning signs—detecting patterns of noncompliance. When I think about the systems we have in place to capture data and analyze trends—employee surveys, customer complaints, a whistle-blower hotline—they're all essentially detective controls. The real challenge is to prevent problems in the first place."

Non-GAAP
"We try to stand in both the investors' and the SEC's shoes to assess the value and reasonableness of the non-GAAP information we're considering. It's also helpful to get feedback from your investors on how they perceive the company's use of non-GAAP—whether it's through your investor relations department or as part of your direct engagement with shareholders. Ultimately, it's your investors who need to understand the company's story."

Audit committee's workload and effectiveness
"It takes strong leadership to keep control of the audit committee's agenda. It's up to the chair to set the agenda and keep the committee focused. If it isn't in the committee's charter, the chair has to push back. Say no—and talk to the nominating and governance chair."
For a full summary of KPMG's peer exchange discussions, see "Risk just got riskier" at kpmg.com/aci.

Building a visionary, strategic-asset board

An increasingly complex and volatile business and risk environment—coupled with higher expectations for board performance—have made building and maintaining high-performing boards a critical area of focus for investors and boards.

The panel, led by Dennis T. Whalen, leader of the KPMG Board Leadership Center, discussed how leading boards are moving beyond traditional approaches to board "refreshment" to a system for continuous improvement in the boardroom. Panelists discussed the findings and recommendations of the Report of the NACD 2016 Blue Ribbon Commission on Building a Strategic-Asset Board, and insights from the WomenCorporateDirectors Foundation and KPMG report, *Seeing far and seeing wide: moving toward a visionary board.*

The increasing focus on board composition in recent years has been driven in part by concerns about board tenure and refreshment raised by institutional investors, who have cited low director turnover and long tenures.

Peter Gleason, president and CEO of the NACD, emphasized that, "There needs to be a continuous improvement mindset on boards where they're constantly looking at the board's makeup, how it aligns with the strategy, and what the board will need going forward."

Director term and/or age limits can help to increase board turnover; however, on their own, they are insufficient and may not address the underlying issue of whether the directors who currently serve on the board are still the "right" directors to guide the company forward.

Susan Stautberg, Peter Gleason, Virginia Boulet, Dennis Whalen

continued on pg 4

continued from pg 3

Gleason also emphasized the need for boards to dispel the stigma associated with stepping off of a board by changing the widely held view that a directorship is a lifetime position. "We need to make it clear that serving on a board is not a Supreme Court appointment," said Gleason. "Boards need to take a clean-sheet approach to composition to look at the skills and talent they have compared to those that they need to bring on to stay fit for purpose."

Today's boards are clearly held accountable for strategy, one director commented, adding, "Our board has morphed as the company's strategy has evolved. We've changed the way we select directors, the way we prepare for and conduct meetings, and the way we self-analyze our performance."

Susan Stautberg, chairman and CEO of the WomenCorporateDirectors Foundation, said, "Vision in the boardroom is an imperative today. By definition, a visionary board is a diverse board: multi-gender, multi-geography, multi-generation, and multi-industry."

A new mindset in cybersecurity

The cyber-risk landscape remains fluid and opaque, with breaches not a matter of if, but when and how severe. New vulnerabilities posed by the sensor-driven Internet of Things, new products, M&A and expansion into new geographies, and third-party "adjacencies" (suppliers, customers, partners, advisers, and others) call for deeper—and perhaps very different—conversations in the boardroom. Directors surveyed at the conference ranked keeping technology systems up to date, third-party and supply chain vulnerabilities, and talent and expertise as the most significant gaps in their companies' ability to manage cyber risk.

How much does the board need to know about how companies are evolving their cybersecurity strategies—from prevention to detection, containment, and response? What is the company doing to elevate the cyber-risk mindset to an enterprise level to manage the potential operational, reputational, and strategic impacts of a major breach?

"Articulating technology risk to the board is a real challenge," said one director, "and adding more capabilities at the board level is not necessarily a good idea. The board should make it a priority to seek out and know the corporate stakeholders in cyber: the chief information security officer (CISO), the risk managers, the operations managers, and the financial risk managers, including internal audit."

"Vulnerabilities are also created by lax enforcement of established policy," said one panelist. "What is the board doing to ensure that policies are being followed? In the event of a hack or breach, the board has to understand the mechanisms and processes and how the company will respond."

"Do you have a plan to engage with law enforcement?" asked one panelist. "Cyber breaches are now about criminals and nation-states. If you think something has been stolen, the first thing the FBI or Department of Justice will ask is 'were you protected?'"

As the field of cyber-risk mitigation evolves, the panelists agreed that they have seen companies attempt to use "too many frameworks" to protect their digital assets, including employee and customer information and communications. "Pick a framework and stick with it."

Finally, the panelists concluded that technological monitoring and intervention alone cannot solve all of a company's cyber vulnerabilities. "The human factor is real," said one panelist, adding that a large percentage of cyber breaches involve bad actors within the company.

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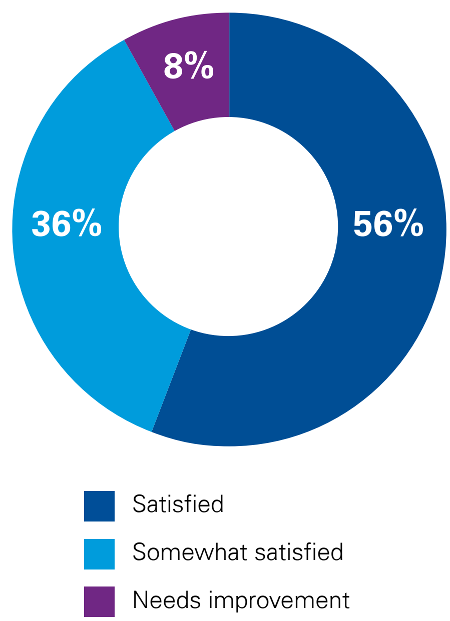
How satisfied are you that your board has the range of experiences and skill sets—including different perspectives and worldviews—to add value in a more globalized business environment?



Source: KPMG Audit Committee Issues Conference survey

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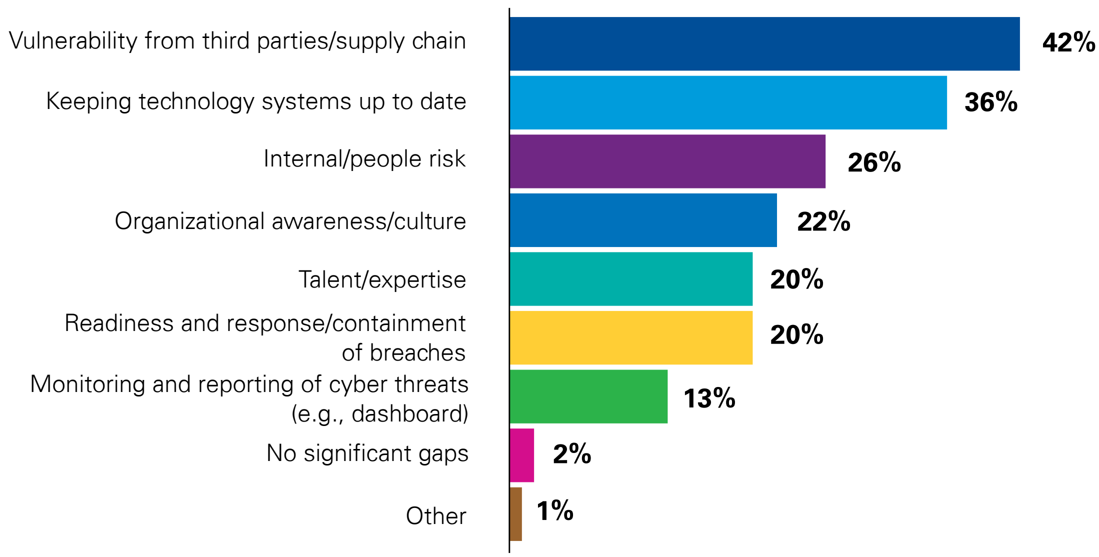
What are the two most significant gaps in your company's ability to manage cyber risk?



Source: 2017 Global Audit Committee Pulse Survey, U.S. respondents

Note: Multiple responses allowed.

Crisis readiness and response: Is the board on board?

In the aftermath of a crisis, the company's—and the board's—actions to prevent, contain, and respond are increasingly examined under a microscope. The list of potential events that companies may find themselves facing looms large, from major product recalls, scandals involving executives, and systemic compliance failures to natural disasters, data breaches, and acts of violence, including terrorism.

Crisis postmortems in the media invariably ask, "Where was the board?" Three experienced crisis and communications executives and advisers led a discussion of how the board's involvement and understanding of the crisis plan can help mitigate fallout. In shaping both crisis readiness and response, one panelist summarized the company's priorities as "Acknowledge, apologize, and act."

In the fast-paced digital era, where news (accurate or not) travels around the world in seconds, a strong, well-implemented plan can help save a company's reputation. In most incidents that evolve into full-blown crises, the board has some role to play. However, preparing effectively for any number of situations by clearly identifying the risks and responsibilities, codifying procedures, and outlining the communication plan can limit the need for direct board involvement except in cases of senior executive concerns, such as gross malfeasance or an unexpected succession.

"A critical first step, and a core function for all boards and many audit committees, is risk identification and how it links to the company's enterprise risk management system," said one panelist. At the operational level, this flows into planning and practice—what types of events should the company prepare for, who needs to be involved, who leads the response, and how robust is the communication plan? "The board should know and understand the response system, including who is responsible and who is the spokesperson."

"In crisis response, speed is one of the most important factors," noted a panelist. "You don't have time to build confidence with your stakeholders: that needs to be done in advance by how the company comports itself both internally and externally."

"Your CEO is likely not your crisis response leader," according to one speaker. "Depending on the level of risk, the company must determine the appropriate person to run point internally and comment externally." In crises that directly involve the CEO, the general counsel, outside counsel, and members of the board will have to be involved.

Another panelist acknowledged the heavy toll a crisis can take on those tasked with responding: "A true crisis is exhausting. Have a green team and a red team ready to rotate in and out. When people are tired, they make mistakes." ■

Corporate leadership reaches an inflection point

Dennis Whalen talks to Tim Nixon of Thomson Reuters about the changing role of the corporation in society

Tim Nixon, managing editor of *Thomson Reuters Sustainability,* sat down with Dennis Whalen, Leader of the KPMG Board Leadership Center, to understand more about why corporate governance is reaching an inflection point, with a new emphasis on transparency, long-term value, and key non-financial factors. This interview is reprinted with permission from *Thomson Reuters Sustainability.*

Sustainability: *As the leader of the KPMG Board Leadership Center (BLC) and someone who boards turn to for insight about where governance is headed, what's top of mind for you today?*

Dennis Whalen: The BLC was created to focus squarely on issues and practices that drive leadership in the boardroom. Leadership has always been essential, but it's clear that corporate governance has reached an inflection point in terms of heightened investor expectations for boards to be more deeply engaged, bring strategic insight and value to the table, really challenge management's strategy and assumptions, and keep everyone's eye on the ball. And it's about understanding how a company's long-term performance hinges on the shared success of all of the company's key stakeholders—its investors, employees, customers, supply chain, and communities. One of the critical leadership issues facing Corporate America today is avoiding the quarterly earnings mentality and focusing on long-term value creation and drivers of that long-term value. This is an issue that's front and center for most investors, and it's right in the board's sweet spot.

Sustainability: *What's the board's role in managing the tension between pressures for quarterly earnings and expectations for a long-term perspective and performance?*

Whalen: It's really a matter of aligning the two. The short-term can't be ignored—near-term objectives and results are necessary. But boards are recognizing that an all-consuming focus on quarterly earnings and 'total shareholder return' can undermine the company's long-term performance if not the sustainability of the business model. The board's role, then, is to help push that time-horizon further out, and alleviate pressures on management for short-term results by setting the right tone, focusing on the durability of the business model, and ensuring that the company is communicating its long-term focus to investors.

But doing that requires understanding the drivers of long-term value for the enterprise. Beyond rear-view financial and operational performance numbers, what metrics are the best indicators that the company is creating long-term value? And is the company communicating the drivers of long-term value to investors?

Sustainability: *What does a healthy mix of near-term and long-term performance metrics look like?*

Whalen: The mix will vary by company and industry, but the traditional measures of financial health—cash flow, growth in revenues and profits, and return on invested capital—are important, though these are historical measurements that don't necessarily tell us about future performance and the potential for future growth and returns. So more companies and directors are putting greater emphasis on key nonfinancial measures or drivers of the long-term health and performance of their organizations, like innovation, customer satisfaction, talent and innovation, reliability and durability of the supply chain, brand and reputation, and increasingly, how the company addresses social and environmental issues.

Sustainability: *Say more about "environmental, social, and governance" (ESG) as a metric, and connecting ESG to corporate performance.*

Whalen: By any name—ESG, corporate social responsibility, sustainability, corporate citizenship—how a company manages environmental and social issues and connects these activities to financial and operational performance is increasingly signals to investors of how well the company is run and its long-term financial sustainability. It's about seeing—and tightening—the connection between social capital and long-term performance.

The notion that doing good and creating value are not mutually exclusive is not new, but how these issues are framed and discussed has a major impact on understanding their importance to the business. And language matters. A boardroom discussion about the connection between environmental stability and the company's financial stability is likely to be more meaningful than a discussion about "global warming."

Sustainability: *What are you hearing from investors, as the users of this information?*

Whalen: Investors expect companies to provide a clear, consistent story about their strategic priorities and long-term goals. So the company needs to bring its investors along this journey, communicating how the company is addressing environmental and social issues, why, and how it benefits the long-term interests of the company and its stakeholders. Talk about the company's progress and results—even if the goals are ambitious and haven't been reached yet—and how it all links to the strategy. In a recent survey we conducted with the *Wall Street Journal*, more than 70 percent of the readers who responded

continued on pg 7

continued from pg 6

said communicating the company's long-term vision and value was equally or more important than communicating quarterly earnings. Similarly, CECP's Strategic Investor Initiative, with $15 trillion in AUM on its advisory board, has launched a forum where CEOs can present long-term plans to long-term investors, and demonstrate the greater sustained earnings power proven to come from longer-term thinking. Investors want to know where the company is headed, how it plans to get there, and how it's doing against that plan.

Sustainability: *What are some practical steps boards can take to help management sharpen their focus on these issues?*

Whalen: In a paper we just developed with Harvard Business Review's Analytic Services, we point to five ways the board can help the company stay focused on the big picture: Helping to set—or reset—the context for the company's discussion of environmental and social issues; understanding whether management has identified key environmental and social risks and opportunities across the enterprise; embedding environmental and social initiatives into the company's strategy; insisting that management clearly communicate the company's environmental and social efforts to investors; and helping to set the tone and culture around environmental and social activities—giving management permission to think and act long-term. The full paper is called *Corporations and Society: Doing Social Good While Doing What's Good for Business.* It's a great boardroom resource for leading the way forward on this. ■

Social responsibility and strategy meet in the boardroom

The context for corporate performance is changing rapidly: Consideration of the corporation's role in society is moving from the periphery to the center of corporate thinking as investors, customers, employees, and other stakeholders are challenging companies to understand the total impact of the company's strategy and actions. A tighter connection between "social capital" and bottom-line performance is being forged.

Call it corporate social responsibility (CSR), sustainability, corporate citizenship, or environmental, social and governance (ESG), how a company manages environmental and social issues—and connects these activities to financial and operational performance—are increasingly signals to investors of how well the company is run and its long-term financial sustainability.

In this environment, it is critical that boards understand how the company is managing the risks and opportunities related to environmental and social issues, and embedding its initiatives into the corporation's strategy and culture. How these issues are framed and discussed has a big impact on understanding why they matter to the business and how to address them. It requires a deep understanding of the business and the issues affecting the company's long-term success.

Today, companies—and boardroom discussions—are moving at different speeds on addressing environmental and social issues, but wherever the company is on this journey, the board can help lead the organization forward by focusing on the big picture:

- Help set (or reset) the context for the company's discussion of environmental and social issues.
- Energize management's assessment of risks and opportunities.
- Embed environmental and social initiatives into the strategy and look at these issues in terms of long-term value creation.
- Tell investors and stakeholders about the company's environmental and social efforts.
- Help set the tone at the top and culture around environmental and social initiatives.

For more information, read *Corporations and Society: Doing Social Good While Doing What's Good for Business,* a KPMG-sponsored Harvard Business Review Analytic Services Report.

Investor intelligence and insights

A fresh look at climate risks and board diversity

by: Stephen L. Brown

When we asked directors last spring which issue they wanted their boards to spend less time on, sustainability/CSR was one of the top responses[1]. A recalibration of priorities, however, may be appropriate given recent pronouncements made by two of the world's largest asset managers, BlackRock and State Street Global Advisors (SSGA).

Recently, both BlackRock and SSGA have emphasized the importance of sustainability and board diversity in public letters to board members[2]. Both stressed their policy positions, their interest in engaging with boards, and offered guidance to boards and management on how to focus on these issues. On gender diversity, both asset managers stated that if their engagements with boards did not yield improvements, then they may effect change by voting against the chair of the nomination and governance committee.

Members of the investment community, generally, have never been afraid to voice their opinions to directors. On climate change and board diversity, many of these views came from environmental and socially focused investors, including state and union pension funds. Now that BlackRock and SSGA have added their influential voices (and votes) to the chorus, the investment community is poised to have greater impact on the corporate approach to climate risks and board diversity.

Below are key points from the investors' guidance and some thoughts for boards on how to prepare.

Environment and Sustainability

In its January 2017 letter to directors, SSGA emphasized the importance of sustainability in long-term corporate strategy, stating "we will be increasingly focused on board oversight of environmental and social sustainability in areas such as climate change, water management, supply chain management, safety issues, workplace diversity and talent management, some or all of which may impact long-term value." SSGA also provided a framework to help boards focus on environmental, social, and governance (ESG) issues, including a list of questions directors can use as a starting point for working with management to incorporate a sustainability lens into long-term strategy. These questions focused on the company's competency in incorporating sustainability with respect to (1) materiality assessments, (2) strategy, (3) capital allocation decisions, (4) long-term strategy, (5) executive compensation, and (6) reporting and disclosures.

In March 2017, BlackRock identified climate risk disclosures as one of its five engagement priorities for 2017–2018, along with board composition, the board's role in strategy, executive compensation, and talent. BlackRock said it would encourage companies "most exposed to climate risk" to consider using the reporting framework developed by the Financial Stability Board Task Force on Climate-related Financial Disclosures.

Board Diversity

In March, SSGA urged companies to increase the number of women on their boards and encouraged boards to set expectations for senior management to enhance gender diversity within their own ranks and the wider organization. SSGA provided a framework which included (1) assessment, (2) goal setting and reporting on progress, (3) addressing possible behavioral bias in the search process, and (4) enhanced transparency and communication with investors.

BlackRock's engagement priority regarding board diversity stated that it "will engage companies to better understand their progress on improving gender balance…If there is no progress within a reasonable time frame, we will hold nominating and/or governance committees accountable for an apparent lack of commitment to board effectiveness."

How a company manages environmental and social issues—and connects these activities with strategy—are important signals to investors of how well the company is run and its long-term financial sustainability. Here are some practice tips for boards:

Consider these pronouncements in context of a "shared governance" paradigm. While climate change and diversity matters may not be a priority of the Trump administration or the SEC, these issues are clearly top of mind for an increasing number of investors. They learned from proxy access that, in lieu of legislation, private ordering can be an alternative path to secure governance wins on matters they believe are important. If investors believe an issue affects long-term value, they will demand engagement with management and directors, enhanced and meaningful disclosure, and will vote against directors if not satisfied.

Assess how the company would fare with investors on climate change and diversity. Level setting is important. The board (or committee(s) of the board) and management should review the questions presented by BlackRock and SSGA to determine where they would stand if they had an engagement discussion with these firms and others today. An honest assessment may uncover weaknesses that can be addressed.

Ensure board "fluency" on climate risks to operations. The board should be able to demonstrate a fluency in how climate risks affects business operations and how the firm is adapting and mitigating those risks. Investors will evaluate company and board disclosures (proxies and engagement discussions) as part of their assessment.

Review disclosures and processes. Disclosure is an important mechanism for communicating with investors. Mandatory and voluntary disclosures on climate issues and diversity should be reviewed, including examples of best practices. Discuss the merits of adopting wholesale or adapting such practices.

continued on pg 9

[1] See KPMG Board Leadership Center, "*Focusing on What Counts,*" 2016

[2] See "*SSGA's Guidance on Enhancing Gender Diversity on Corporate Boards*," 2017 and *BlackRock's investment-stewardship/engagement priorities*, 2017

continued from pg 8

Check management's engagement readiness. Boards should ask management about their shareholder engagement plans and determine whether the engagement team is prepared to effectively tell the company's story. This means adequately preparing directors to engage if necessary. Additionally, boards should query management on the merits and challenges of adoption of the Financial Stability Board's recommendations on climate change disclosures. Further, the nominating committee must be able to explain its board succession and director search process. ■

Stephen L. Brown is Senior Advisor to the KPMG Board Leadership Center. He previously served as head of corporate governance for TIAA.

Blockchain: Where the board should start

The hype around blockchain, the shared ledger at the core of Bitcoin digital currency, became a groundswell in 2016 as total venture capital funding for blockchain-related companies surpassed $1 billion and many major banks, securities exchanges, and governments doubled down on plans to explore opportunities around blockchain.

The potential impact of blockchain—on how business transactions and legal contracts are executed and recorded, IP/data protection and privacy, fraud prevention, voting, auditing, and more—is so fundamental and wide-reaching that observers and early adopters are comparing the current blockchain ecosystem to the early days of the Internet.

"If you had understood in 1995 the opportunities and threats [the Internet] would ultimately present to your company or industry, what would you have done differently? That is where we are with blockchain today," wrote IBM CEO Ginni Romety in *The Wall Street Journal*.

Indeed, experts agree that mainstream use of blockchain is still years away. But executive teams and boards of directors across industries are increasingly adding blockchain as a major game-changer that stands to upend business models and the competitive landscape.

Blockchain defined

A blockchain is a digitally linked chain of transaction records that together form a shared-ledger of account, recording transactions or a sequence of transactions between counterparties. Bitcoin—which represent the most common use of blockchain today—is open and accessible to all, much like the public Internet.

Most corporate and governmental consideration and use of blockchain, however, exists and will exist on a closed or permissioned systems, whereby participants or owners of the network determine who else can participate, observe or initiate transactions.

In addition to facilitating and verifying financial transactions, blockchain technology is being considered and applied in a number of ways. A few examples:

— **Execution of "smart contracts"** – the entirety of a purchase order—from product selection, to multiple approvals, to payment, to shipping and receipt—can cascade automatically without a manual process of communication and confirmation between each step and without complex reconciliation.

— **Validation and compliance** – whereby a third-party (a doctor, attorney, auditor, or regulator) is able to track and confirm a business process, such as a transfer of medical records, payment, securities trade, or even a vote, in real time.

— **Digital identity** – to secure and validate citizenship, birth certificates, education, addresses, relationships and more for use by trusted contacts, financial institutions, schools, and even electronic devices.

"The technology and operating model behind blockchain is interesting, but for companies this is fundamentally a business question," said Phillip Lageschulte, KPMG U.S. network leader for Emerging Technology Risk. "Companies have to evaluate which of their business issues blockchain can help solve, and how it may impact strategic decisions and residual risk." He cautions that companies must begin now to develop a clear understanding of the opportunity and challenges presented by blockchain for their existing or emerging business models and operating platforms, and that understanding of risk and reward ultimately has to reach the board.

"Of course, the other side of these blockchain-related opportunities are the benefits and the competitive risks," said Eamonn Maguire, KPMG's Global Financial Services lead for Digital Ledger Services. "If blockchain hasn't made it into the company's boardroom conversation yet, it needs to be on the agenda as both a strategic matter and a competitive risk."

continued on pg 10

continued from pg 9

With start-ups and established companies rapidly innovating around blockchain, directors and executives can start with the following actions:

1. Educate yourself about the disruptive potential and threat posed by blockchain, and ensure that the executive team is doing the same.
2. Determine whether the company needs to develop a strategy and roadmap for implementing blockchain within the enterprise and with other third parties.
3. Understand how the company intends to nurture, foster, incubate, partner, invest or acquire blockchain and digital ledger skills and capabilities.
4. Seek out industry blockchain and digital ledger partnerships, consortia, standard-setting bodies and other collaborations as early as possible.
5. Expect management to work toward identifying and qualifying use cases, based on both return on investment and a robust business case.

For more in-depth analysis, read ***Missing Link: Navigating the disruption risks of blockchain*** and ***Consensus: Immutable agreement for the Internet of value.*** ■

Financial reporting and auditing update

On January 1, 2018, the new revenue standard will be effective for public companies with a calendar year-end, and the new lease accounting standard will be effective one year later. Companies can no longer delay their implementation efforts for either standard, and are urged to evaluate the benefits of adopting these standards concurrently. Meanwhile, the SEC staff continues its focus on non-GAAP financial measures, internal control over financial reporting and the need for useful pre-adoption and transition disclosures, particularly for the new revenue, lease accounting and credit loss standards. These as well other accounting and financial reporting developments potentially affecting you in the current period or in the months ahead, are summarized below. (For more detail about these and other issues, see KPMG's *Quarterly Outlook* and related KPMG publications.)

Considering the Impact of Trump Administration Policies on Financial Reporting and Disclosures

There has been much discussion in the financial press regarding the potential impact of the new administration's policies on U.S. businesses—from operating in a stronger U.S. dollar environment and the likelihood of higher interest rates, to changes in major trade agreements and tariffs, to corporate tax reform, healthcare reform, and infrastructure initiatives. In this environment, management teams and boards will need to regularly reassess the continuing validity of the company's critical strategy and risk assumptions, and audit committees should discuss with management the potential impact of the new administration's policy initiatives on the company's financial reporting and disclosures—including risk factor disclosures, earnings guidance, tax accounting, balance sheet, and debt covenants.

Current Quarter Financial Reporting Matters

SEC Staff Comment letters – Areas of Focus. SEC staff has commented on a range of topics in its recent filing reviews:

Internal control over financial reporting. The SEC staff continues to comment on internal control over financial reporting (ICOFR). SEC staff comments about companies' assessments of ICOFR and disclosures include but are not limited to failure to disclose material changes to ICOFR; immaterial error corrections; inadequate description of control failures; inconsistency between conclusions (e.g. concluding that disclosure controls and procedures were ineffective but ICOFR was effective); disclosures about the status of remediation of a previously identified material weakness; and disclosures regarding various administrative deficiencies.

Transition disclosures about new accounting standards. In September 2016, the SEC staff announced that when a company does not know and cannot reasonably estimate the effects of adopting a new accounting standard, it should consider additional qualitative financial statement disclosures to help users understand the potential significance of those effects. The SEC staff expects a company to describe the new accounting policies that it expects to apply, and compare those policies with its current accounting policies. In addition, a company should describe its progress toward implementing the new standard and the significant implementation matters that it still must address. The staff intends to comment on materially deficient disclosures, particularly those addressing the new revenue, lease accounting, and credit loss standards.

Non-GAAP financial measures. The SEC staff says it has seen improvements but continues to observe noncompliance since May 2016, when the SEC published

continued on pg 11

continued from pg 10

additional Compliance & Disclosure Interpretations (C&DIs) that describe prohibited practices relating to non-GAAP disclosures. The SEC staff has recently issued comments when companies:

- Present non-GAAP financial measures more prominently than GAAP measures
- Provide potentially misleading financial measures by, for example:
  - Excluding normal operating expenses
  - Computing the measures inconsistently between periods
  - Including gains, but excluding charges
  - Tailoring individual accounting principles
- Disclose per share non-GAAP liquidity measures (which are prohibited)
- Present earnings before interest and taxes; earnings before interest, taxes, depreciation, and amortization; or free cash flow without reconciling it to a GAAP measure.

Companies and their audit committees should periodically evaluate and document the population of non-GAAP financial measures, how they are used and why they are important to investors and other users. Companies also need to consider how well they incorporate the development and review of non-GAAP financial measures into their disclosure controls and procedures.

Other SEC staff areas of focus. The SEC staff has also frequently commented on management's discussion and analysis, fair value measurements and disclosure, income taxes, intangible assets and goodwill, revenue recognition, segment reporting, acquisitions and business combinations, debt/equity, and commitments and contingencies.

Upcoming Financial Reporting Matters

Continuing the discussion about revenue. While companies continued to make progress on their implementation of the revenue standard in 2016, many have more work to do as January 1, 2018 quickly approaches. Recent surveys indicate a majority of companies are still assessing the effect that the new standard will have on their business. Where implementation is lagging behind plan or users' expectations, companies and their auditors should discuss the reasons for delay with audit committees. As noted above, management also needs to provide informative disclosures about implementation progress and the significant implementation matters they still must address. Companies likely will need to update their internal controls over financial reporting as they implement the new standard, including controls over measuring the transition adjustments and preparing the expanded disclosures.

Adopting the lease accounting standard. The new lease accounting standard is not effective for public companies until fiscal years beginning after December 15, 2018 (i.e., 2019 for calendar year-end public companies), and one year later for all other entities. However, companies should take steps today to prepare for timely implementation. Lessees and lessors may find that adopting the new lease accounting and revenue standards concurrently minimizes the extent of systems and process changes, and provides financial statement users with more comparable year-over-year information. Lessors may be particularly interested in concurrent adoption because key aspects of the revenue and lease accounting models are substantially aligned. Concurrent adoption may enable companies to benefit from the synergies between the revenue and lease guidance sooner, and avoid complexities that could arise from continuing to apply a lessor model that is not aligned with the revenue guidance. Additionally, lessees may consider early adoption to take advantage of the revised guidance and transition provisions for sale-leaseback and build-to-suit accounting.

Moving forward on financial instruments. The FASB's new financial instruments standards that address (i) recognition and measurement and (ii) credit impairment are not effective for calendar year-end public companies until 2018 and 2020, respectively. However, companies should promptly begin to analyze the practical business implications of adopting these standards, and consider the adequacy of their disclosures about the expected effects of adopting the standards. ■

Mark your calendar

Building the Strategic Asset Board, New York
April 25

This half-day event will explore in more depth some key elements of the recent NACD Blue Ribbon Commission Report on Building the Strategic Asset Board. Topics include, communicating with investors, how to effectively work with the CEO and be a true asset to the C-suite, and how to implement a process that ensures continuous development of the board's skill sets and processes.

Find more at *NACDOnline.org.*

WomenCorporateDirectors Global Institute, New York
May 9–11

Beginning with the Family Business Governance Institute on May 9, the WomenCorporateDirectors Global Institute will include panels, discussions, and roundtables on leadership, technology, governance, transactions, and transitions among other topics. The Visionary Awards Dinner will be held on May 10.

Find more information and register at *womencorporatedirectors.com.*

KPMG Spring 2017 Director Roundtable Series
mid-May to mid-June

To be held in approximately 20 cities, the Spring Roundtable series—*Assessing the potential impact of the Trump Administration agenda*—will explore key considerations and questions shaping boardroom conversations in the current environment, including which policy initiatives may have the greatest impact (positive or negative) on the business; how management is assessing the potential impact of these initiatives on the company's critical strategy and risk assumptions; and whether the company has the right level of focus and resources devoted to the effort.

Find more information and register at *kpmg.com/blcroundtable.*

KPMG/NACD Quarterly Audit Committee Webcast
June 22

The quarterly webcast from KPMG's Audit Committee Institute will include financial reporting and corporate governance updates.

Find more information at *kpmg.com/aciwebcast.*

NACD Master Class, Chicago
June 22–23

This advanced foundation course from NACD offers a forum for seasoned, public company board leaders to share insights and create "next practices" to lead their board through periods of rapid change and unprecedented opportunity for innovation.

Find information at *NACDOnline.org.*

KPMG Board Leadership Conference, San Diego
January 8–10, 2018

Find more information at *kpmg.com/blc.*

Selected reading

The Year in Crisis: 2016 (Economist Intelligence Unit)

Where Companies with a Long-Term View Outperform Their Peers (McKinsey)

Five Steps to Tackling Culture (KPMG)

Seven for 17: Tactical Approaches to Proxy Season (Teneo)

Why Boards Aren't Dealing with Cyberthreats (Harvard Business Review)

To receive articles like these from *Board Leadership Weekly*, register at kpmg.com/blcregister.

About the KPMG Board Leadership Center
The KPMG Board Leadership Center champions outstanding governance to help drive long-term corporate value and enhance investor confidence. Through an array of programs and perspectives—including KPMG's Audit Committee Institute and Private Markets Group, the WomenCorporateDirectors Foundation, and more—the Center engages with directors and business leaders to help articulate their challenges and promote continuous improvement. Drawing on insights from KPMG professionals and governance experts worldwide, the Center delivers practical thought leadership—on risk and strategy, talent and technology, globalization and compliance, financial reporting and audit quality, and more—all through a board lens. Learn more at kpmg.com/blc.

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