Directors Quarterly

Insights from the Board Leadership Center

July 2017

What's inside

Confidence, concern, and anticipation

Q3 may well be a summer of anticipation. Despite a slow-growing U.S. economy—with low inflation and low oil prices, modest wage growth, and apparent slack in labor markets—the Fed's June rate hike suggests a mix of concern and confidence going forward, with a nod to the complexity of factors at play. Tax reform and a major infrastructure program, both in limbo, would no doubt accelerate growth; trade deals, tariffs, and immigration policies remain under the microscope—and looming question marks for U.S. manufacturers, importers, and industries relying on talent from abroad; and geopolitics and the pull-back on globalization continue to fray and test relationships in markets around the world.

Beyond the Beltway malaise, technology continues to boost productivity through automation and operational efficiencies but with very real implications for workers and future jobs; data analytics is driving innovation and competitive insight with ever-more sophisticated algorithms and artificial intelligence; and, not surprisingly, cybersecurity continues to climb on business and board agendas as data, now "the world's most valuable resource,"[1] takes its place alongside talent and capital as a critical business asset.

This quarter, we look at this mix of confidence, concern, and anticipation from a number of perspectives: KPMG's 2017 CEO Outlook Survey, where chief executives express confidence in the economy and technology-driven innovation and disruption but worry about their ability to keep pace with technology and the reliability (and safety) of their data; our recent Spring Roundtable Series found many companies focused on scenario planning and anticipating at least one major shift in strategy as a result of the Trump administration's policy initiatives; and our ongoing dialogue with investors continues to highlight rising investor expectations for board engagement, effectiveness, and a focus on long-term performance. We also cover key financial reporting and auditing developments—including the PCAOB's new standard requiring that the auditor's report include discussion of "critical audit matters" and key areas of SEC staff focus.

We hope you find *Directors Quarterly* to be a helpful addition to your summer reading.

Dennis T. Whalen
Leader
KPMG Board Leadership Center

[1] "The world's most valuable resource is no longer oil, but data," *The Economist*, May 6, 2017.

U.S. CEO Outlook 2017: Disrupt and grow

Most CEOs in the U.S. have a positive outlook on economic growth over the next three years—particularly in the U.S. market, according to KPMG's annual survey of CEOs. An increasing number of chief executives are also getting more comfortable with rapid, technology-driven change, appreciating the value of disruption and the potential that accompanies it; six out of 10 CEOs now view technology as an opportunity rather than a threat.

What are CEOs concerned about?

Indeed, from data and analytics to cognitive and robotics, CEOs see technology as transformational; yet, 4 out of 10 are concerned about whether their organization is keeping up with new technology; 6 out of 10 are concerned that their organization does not have the sensory capabilities and innovative processes to respond to rapid disruption; and nearly half are worried about the quality of their data—the basis for automation, cognitive computing, and understanding their customers.

"It's natural that nearly half of CEOs would express concern about relying on data they are not sure they can trust," said Brad Fisher, U.S. Leader, Data and Analytics, KPMG, noting that organizations are getting much more data, and more types of data, than ever before—and often from external sources that lack robust controls. "This is part of the anxiety CEOs express about implementing technologies that rely on that data, such as artificial intelligence and cognitive computing. To make matters worse, artificial intelligence analytics are effectively a 'black box' that is too opaque to be verified by most people. Since it's difficult to see inside the box, trust becomes more important, but also difficult to obtain."

Transparency in data science processes to better understand and rely on the analytics, says Fisher, will be key to gaining confidence and trust in the data.

Among other technology and data-related findings from the survey:

- 57 percent say their organizations do not have the sensory capabilities and innovative processes to respond to rapid disruption
- 32 percent of CEOs say the depth of their customer insight is hindered by a lack of quality customer data
- 76 percent see investment in cybersecurity as an opportunity to find new revenue streams and innovate, rather than as an overhead cost.

For more insights from the 2017 U.S. CEO Outlook, visit kpmg.com/us/ceooutlook.

Boards struggle to assess impact of Trump administration agenda

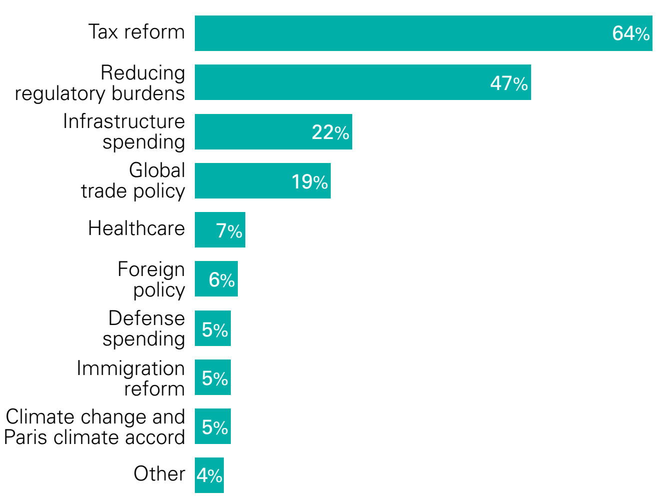
Even as the broad outlines of the Trump administration's agenda take shape, an uneven start, lack of progress on key policy initiatives, and ongoing investigations of potential Russian meddling in the U.S. election have made it a challenge for companies to cut through the noise and prepare for potentially sweeping legislative and policy changes.

Tax reform, infrastructure investment, regulatory easing, trade and immigration policy, and other prospective policy shifts—all of which pose significant risks and opportunities—are high on board agendas as directors help their companies assess the potential impact on business strategies, risk profiles, and operations.

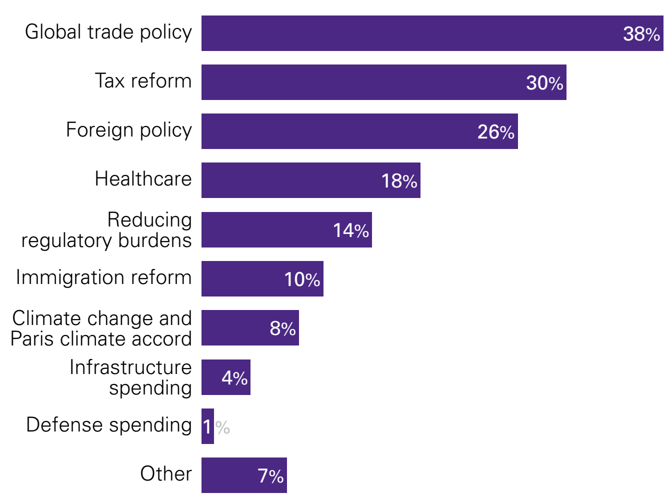
Some 40 percent of the directors and business leaders surveyed by the KPMG Board Leadership Center during our Spring Director Roundtable Series said they anticipate their company making at least one significant change to its strategy; yet, it was also clear from the roundtable discussions that while agility will be essential, many companies remain focused on the long term. "We need to ensure we stay focused on the company's long-term goals, but we also need to make sure we can pivot as needed," one director said. Another noted that while the company will need to be "ready to make any appropriate adjustments once we know what the policies are, we're playing the long game and taking a measured view."

Scenario planning is playing an important part in helping their companies to prepare to respond to any shifts in the business environment that could come about amid policy or regulatory moves. About 40 percent of those responding to the survey reported that their company management has created probability scenarios around the policy initiatives that would have the greatest impact on their company's strategy. "We're not changing our strategy, but we are constantly modeling what it would look like." Another noted that, "There are still too many moving parts. We aren't looking at scenarios, we're talking about the risks around our strategic plan and how we're doing."

Which of the Trump administration's policy initiatives will pose the greatest opportunity for your company's growth? (Select all that apply.)



Which of the Trump administration's policy initiatives pose the greatest risk to your company's strategy? (Select all that apply.)



Based on responses from 325 directors and business leaders surveyed in May and June during the KPMG Spring Director Roundtable Series.

For more insights from the roundtable series and results of our survey, visit kpmg.com/blc.

Spotlight on director-investor engagement

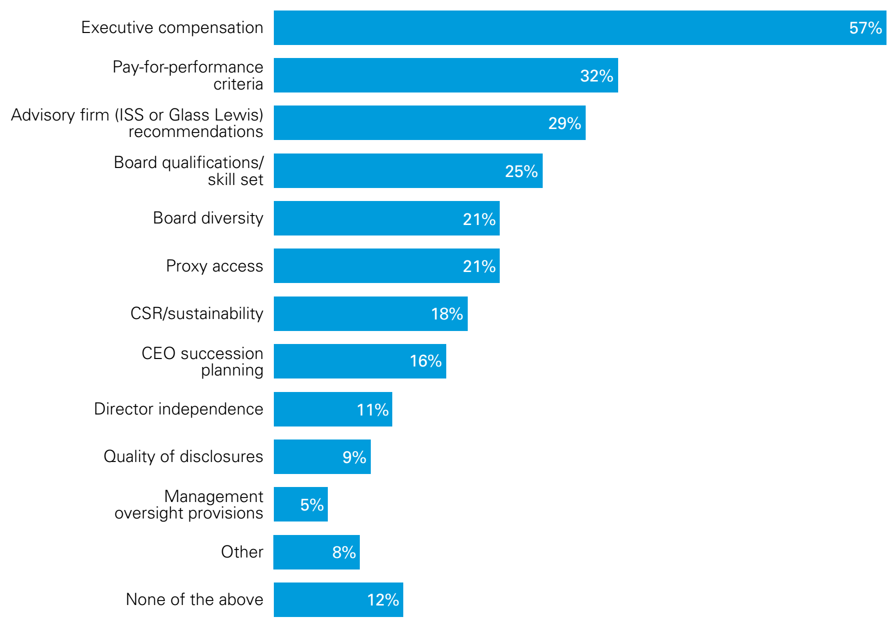
In the current environment, the question that corporate boards should be asking with respect to shareholder engagement is no longer if, but how. Engagement with the company's significant shareholders is becoming the new normal, rather than the exception. Given heightened investor expectations for transparency in governance and oversight, having a well-executed plan for communicating the company's story and gauging investor sentiment on key issues is critical. It is also increasingly important that the entire board knows what that plan is and what role the directors may play.

"When things go wrong, investors… get one vote, and that's on directors," said Stephen Brown, Senior Advisor, KPMG Board Leadership Center. Brown and Lopa Zielinski, currently deputy corporate secretary at HSBC in North America, both former governance leaders for a major institutional investor, joined Faye Wattleton, managing director at Alvarez & Marsal and director on several public and private company boards, for a panel discussion on communications between shareholders and boards. The discussion, moderated by Susan Angele, also a senior advisor with the KPMG Board Leadership Center, took place during the WomenCorporateDirectors 2017 Global Institute in New York in May.

The panel discussed the corporate governance issues most often raised by institutional investors, offered examples of engagement scenarios that boards could face, and provided tips for engagement.

Notably, activist hedge funds are not the only investor demographic driving the need for engagement. "[More traditional institutional investors] are becoming much more active, whether it's on board composition issues, company performance, or social responsibility issues, they are all over it, and they're starting to use their votes more and more to drive the change that they want to see," said Angele. These investors include state and local pension funds, not-for-profit foundations, and university endowments.

Corporate governance issues most often raised by investment professionals



Source: Rivel Research Group, Corporate Secretary Flashpoint: Institutional Investor Engagement, March 2016

Data from Rivel Research Group ranked executive compensation, pay-for-performance criteria, advisory firm recommendations, board qualifications and skills, board diversity, proxy access and corporate social responsibility/ sustainability as the issues raised most often by institutional investors.

According to Brown, investors have three main factors on which to evaluate companies and directors: price, personnel, and processes. "Information on the first two is easy to get, but on board processes, investors have very limited information. If your company has good processes, it's important to explain it to investors to help to demonstrate board competence."

Spotlight on director-investor engagement *continued*

Wattleton added, "Investors want to know that there is rigor in the [board's] process—not only on why you got there, but how you got there."

Zielinski emphasized that investors are not interested in a repetition of the company's public disclosure. "They're looking for companies to articulate the underlying philosophies behind your story," she said. "How does this support your strategy? How is this going to be sustainable? They want a deeper conversation."

Save the date

KPMG Board Leadership Conference

January 8–10, 2018

San Diego, CA

kpmg.com/blc

Four key takeaways emerged from the discussion:

1. **Engagement is the new normal.** To understand how directors are carrying out their fiduciary duties, investors want and expect to hear from board members. While there is no one "right" way to engage, there are plenty of poor ways to do it—such as not preparing or waiting until a crisis erupts.

2. **Know the plan.** Directors should ask management for details of the company's engagement plan as well as the role they may play. What issues will the company engage with investors on, who will be involved, and when will engagement occur?

3. **Execution is key.** Substance and style matter. The board should understand the depth of the company's investor relations capabilities as well any third-party resources available. Does the company have the appropriate chain of command and protocols in place to ensure that the board receives the critical engagement information it needs? Mock engagement exercises may be useful.

4. **Understand investor concerns.** Investors' governance policies and concerns may vary widely. The board and management should be informed on the governance concerns and views of the company's most significant shareholders and should be prepared to discuss the company's position on those issues and the rationale behind it. It is important to gauge the sentiment of the company's largest investors ahead of governance changes, particularly on issues that shareholders have expressed concerns about. Shareholder proposals serve as a bellwether of the issues that investors are focused on, even when they do not receive majority shareholder support. The board should understand the implications of opposing proposals from large or influential shareholders.

Upcoming panels and events can be found at https://www.womencorporatedirectors.org.

How fund boards approach the active/passive debate

"Since the end of 2006, investors have withdrawn nearly $1.2 trillion from actively managed U.S. equity mutual funds and have allocated roughly $1.4 trillion to U.S. equity index funds and exchange-traded funds (ETFs)," wrote Credit Suisse strategist Michael Mauboussin in January.

In 2017, that trend has continued without abatement, concentrated mostly in large-cap U.S. equities, but low expense ratios for index funds generally have piled pressure on both portfolio managers and fund boards to compete in a rapidly shifting market.

Citing takeaways from Mauboussin's "Looking For Easy Games: How Passive Investing Shapes Active Management," Declan Lee, partner, KPMG, challenged his June 15 panel in Boston to consider how mutual fund directors are being impacted by the wave of assets and investors moving to index funds.

"It's critical, as a director, that you are focused on satisfying the existing shareholders. Even in this environment, we still spend significant time understanding the manager's performance and their relative performance," said Susan Sweeney, audit committee chair, MassMutual Funds, who has experience in oversight of both active and passively managed investment strategies.

"We've heard discussions of fulcrum fees, a performance incentive, and whether those make the portfolio managers better or worse aligned with shareholders," said Bob Boyda, senior managing director, portfolio solutions group, Manulife Asset Management. "That could help with performance, on the margin, but it's not transformative."

Boyda suggested that fund boards could consider expanding manager mandates for more flexibility: "Get more active. What about leverage and derivatives? Illiquid assets?"

"I expect that regulators may be looking more carefully at new and existing passive products, especially those that purport to pursue 'self-indexed' strategies," said Ben Haskin, partner, Willkie Farr & Gallagher. "For directors on these funds, make sure that there is a rulebook that is consistent with the exemptive relief."

"Challenge the manager and the organization. Could they take 40 percent of their costs out? What about outsourcing distribution?" asked Boyda.

For more, read *Evolving Investment Management Regulation: succeeding in an uncertain landscape* by KPMG International.

Financial reporting and auditing update

As referenced in our cover message this quarter, uncertainty in the U.S. regarding the Trump administration's legislative and regulatory agenda as well as worldwide geopolitical uncertainty, including the speed of the UK's Brexit (hard or soft), will require continued attention as companies update their risk factor disclosures relating to these events in their quarterly and annual filings.

And with the effective date of the new revenue recognition standard for public companies quickly approaching, implementation efforts by companies are (or should be) in high gear, and stakeholders and regulators are keeping a watchful eye on their progress.

The SEC continues to stress key areas of focus related to the implementation the new revenue standard as well as new lease accounting and credit impairment standards, including the importance of updating and maintaining internal controls; expectations regarding robust transition disclosures; and whether transition to the new standards may pose new risks, including fraud risks. These and other accounting and financial reporting developments potentially affecting your company 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*.

Current quarter financial reporting matters

SEC under new leadership

On May 4, Jay Clayton was sworn into office as the 32nd chairman of the SEC. Since taking office, Clayton has filled numerous key roles at the SEC, including the appointment of William Hinman as the new director of the SEC's Division of Corporation Finance.

SEC staff comment letters—areas of focus

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 have, in general, focused on failure to disclose material changes to ICOFR; 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, 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.

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

A company should describe its progress toward implementing the new revenue recognition standard and the significant implementation matters that it still must address.

New standards and guidance

Revenue effective date draws near

As the effective date of the new revenue standard quickly approaches (January 1, 2018 for public companies), companies continue to make progress on their implementation efforts—but many have more work to do. 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. As SEC staff has recently emphasized, 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.

Implementing the new 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 be taking steps now to prepare for timely implementation, including: evaluating the benefits of early adoption; creating an inventory of all leases; determining whether to elect the transition practical expedients; evaluating incremental system and process changes (e.g., to prepare the required disclosures); and evaluating the adequacy of transition disclosures.

Companies likely will need to update their internal controls over financial reporting as they implement the new standard.

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.

PCAOB adopts new standard to enhance the auditor's report

On June 1, the PCAOB adopted a new auditing standard that, subject to SEC approval, will require the auditor to include in the audit's report a discussion of critical audit matters (CAMs). The standard defines CAMs as matters that have been communicated to the audit committee, are related to accounts or disclosures that are material to the financial statements, and involve especially challenging, subjective, or complex auditor judgment.

Under the new standard, the auditor's report will disclose, among other things, the tenure of an auditor, and will also include the phrase "whether due to error or fraud" in describing the auditor's responsibility under PCAOB standards to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatements. The new standard retains the pass/fail model of the existing auditor's report.

The Board approved the following phased approach to the effective dates for the new standard:

- New auditor's report format, tenure, and other information: audits for fiscal years ending on or after December 15, 2017
- Communication of CAMs for audit of large accelerated filers: audits for fiscal years ending on or after June 30, 2019
- Communication of CAMs for audits of all other companies: audits for fiscal years ending on or after December 15, 2020.

Audit committees should take advantage of the delay in the effectiveness of the CAM reporting to develop a protocol with their auditor regarding the identification of CAMs the auditor intends to disclose, the nature of the disclosures, and how the management's disclosures will compare to the auditor's.

Investor Intelligence and Insights

Room for improvement on evaluations

by Stephen L. Brown

Corporate board proceedings remain among the most closely guarded discussions in American business, but an ongoing focus by investors on director quality and qualifications since the financial crisis has compelled boards to consider greater transparency on issues such as board composition, tenure, term limits, and diversity.

Seeking to reinforce their position as effective stewards of capital, institutional investors have shown greater interest in who serves on the boards of their portfolio companies and how those boards operate, including how they self-evaluate. While it is already the norm in Europe, U.S. investors are starting to demand more information from issuers about the board assessment process.

Two recent surveys on board evaluations and effectiveness, conducted separately by the Rock Center for Corporate Governance at Stanford University and The Miles Group[2] and by Rivel Research Group[3], show considerable opportunity for improvement in the evaluation process and disclosure.

[2] David F. Larcker et al., Board of Directors Evaluation and Effectiveness, Rock Center of Corporate Governance, Stanford Graduate School of Business in collaboration with The Miles Group, November 2016. Based on a survey of 187 directors of public and private companies in North America.

[3] Rivel Research Group, "Disclosure and the Board of Evaluation Process: Where to Proxy Voters Stand Today?" and companion report "Evaluating Board Effectiveness," March 2017. Reports are based on 71 in-depth telephone interviews with proxy voters at North American and European institutions (51 and 20, respectively).

Dissatisfaction on both sides

The Stanford survey indicated that many directors are dissatisfied with the board evaluation process, particularly the assessment of individual directors. Only 36 percent of directors surveyed believed that their company does a very good job of accurately assessing the performance of individual directors.

Investors held similarly negative perceptions about the effectiveness of board evaluations. A combined 56 percent of investors surveyed by Rivel said that companies do not assess their boards that well or do so "very poorly," and only 28 percent believe that directors take the evaluation process "very seriously."

Effectiveness laid bare

Shareholders have long raised concerns about a lack of effective processes to remove underperforming directors and too much collegiality in the boardroom. The Stanford study may confirm some long-held suspicions.

According to the study, only 46 percent of the directors surveyed strongly believe that their board tolerates dissent, only 52 percent believe their board is very effective in dealing with directors who are underperforming or exhibit poor behavior, and 53 percent believe that directors do not express their honest opinions in the presence of management. Moreover, 35 percent said their boards do not have a structured process for removing ineffective directors, only 23 percent rated their boards as very effective at giving direct feedback to directors, and 54 percent said that if they had sole power to do so, they would have one or more of their fellow board members removed.

Making progress

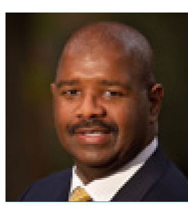
Positive news, however, emerges from both studies. The Stanford study shows that 89 percent of directors believe their boards have the skills and experience necessary to oversee the company and 73 percent say that the individual directors on their board are extremely or very effective. The Rivel study identified industry knowledge/experience (32 percent) as investors' most essential personal attribute for an ideal board member. Nonetheless, courage (the ability and willingness to stand up and ask questions) was second (24 percent), reinforcing investor expectations for boards to act as a credible check on management's power.

The Rivel study also showed that, while they would like to see companies disclose additional information about their evaluations, investors took note of recent improvements in disclosure. Investors said that increased disclosure would also be helpful to them in supporting director renomination.

Next steps

The Stanford study demonstrates that even directors themselves believe that there is work to be done to make evaluations more effective and useful. The Rivel study shows that, with respect to evaluations, directors have a credibility problem with investors. For greater impact, boards should strive to demonstrate the seriousness and validity of their evaluation process. A robust process should pull back the curtain on the evaluation methodology and explain how the results will be used.[4] Further, boards should improve related disclosure. You can't get credit for having a robust evaluation process if your investors don't know about it.

Efforts to improve board evaluations and disclosure will be a win-win for directors. Not only will it lead to more effective boards, it will aid investor assessment of directors when they are in the proxy voting booth.



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

[4] For further discussion and recommendations for board evaluations and assessments see: Enhancing evaluations for boards, committees, and directors

Mark your calendar

NACD Master Class, Laguna Beach, CA
August 17–18

A two-day advanced thought-leadership forum for experienced directors that includes a mix of panel discussions, keynote presentations, peer exchanges, case studies, and networking opportunities.

To learn more, visit *NACDonline.org.*

2017 ASPAC Institute, Hong Kong
September 27–28

A program for women directors from across the Asia Pacific region featuring keynotes and panel discussions.

To learn more, visit *www.womencorporatedirectors.org*.

Audit Committee and Private Company Forums—NACD Global Board Leaders' Summit, National Harbor, MD
October 2

During NACD's annual summit, October 1–4, KPMG is sponsoring daylong programs for audit committee members and private company directors, separately, to cover issues that are top of mind, from the increasing importance of data and analytics in financial decisions to the role of private equity in shaping private company decisions.

Register at *NACDonline.org/summit.*

Financial Times Outstanding Directors Exchange, New York
November 1–2

Join the Financial Times, KPMG, and other partners for a day-and-a-half, off-the-record discussion of critical boardroom concerns for sitting public company directors. Topics to be discussed include innovation as a board priority; questions boards should be asking about geopolitical risk; how to leverage expertise; and defining, and disclosing, diversity.

Register at *live.ft.com.*

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

The Board Leadership Center's annual conference for corporate directors will feature keynotes and panel discussion on issues effecting corporate boards in 2018 and beyond, including guests Michael Lewis, Ian Bremmer, and former White House communications chief Nicolle Wallace and press secretary Jay Carney.

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

Suggested reading

U.S. CEO Outlook *KPMG*

Investors Gets Serious About ESG's Link to Long-Term Corporate Performance *KPMG Board Leadership Center*

The Benefits of Thinking Like an Activist Investor
McKinsey & Co.

How to Thrive in an Era of Shifting Trade Policy
Boston Consulting Group

Securing the Chain *KPMG*

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, the WomenCorporateDirectors Foundation, and more— the Center engages with directors and business leaders to help articulate their challenges and promote continuous improvement of public- and private-company governance. 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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