KPMG

Directors Quarterly

Insights from the Board Leadership Center

January 2018

What's inside

"Focusing on long-term value creation for the company and its stakeholders is job number one."

On the 2018 agenda

A global economy at full throttle—with emerging and developed economies all moving forward and global output at its fastest pace since 2010—bodes well for the year ahead. In the U.S., confidence among consumers and small businesses is high and relatively low interest rates should fuel a respectable 2.5 percent growth rate (which recent tax cuts could push higher). Yet, economists are already watching for signs of a downturn as we reach the historic top of the boom-and-bust cycle (8–10 years), with central bankers nudging interest rates higher and unwinding quantitative easing. The good news is that businesses can anticipate solid growth in 2018 and prepare for any slowdown on the horizon. But little else across the business landscape—risk, talent, technology and digital disruption, geopolitical unrest, climate—will be so accommodating for business leaders.

In this edition of *Directors Quarterly*, we highlight key considerations for boards helping to guide their companies forward in the year ahead. Focusing on long-term value creation for the company and its stakeholders is job number one. Also high on our list: anticipating continued disruption, with "digital" at its core; focusing on corporate culture—aligning personal values and purpose, and understanding the tone at the top, mood in the middle, and buzz at the bottom; learning to live with cyber risk; effectively engaging with investors (including activists); and perhaps most importantly, building a board that is fit-for-purpose, recognizing that diversity and healthy turnover are essential. We also share our thoughts on how audit committees can sharpen their agendas and make the most of their time together—paying close attention to talent and leadership in the finance organization, monitoring implementation of revenue recognition and other new standards, reinforcing audit quality and transparency, and focusing internal audit on key risks beyond financial reporting..

Also in this edition—timely financial reporting and auditing developments from the recent AICPA conference and the PCAOB, initial thoughts on accounting implications of the recently-signed tax reform law, and a look at some of the top issues investors will focus on in 2018.

We hope you find *Directors Quarterly* helpful in sharpening your board and committee agendas for the risks and opportunities in the year ahead.

Dennis T. Whalen
Leader
KPMG Board Leadership Center

On the 2018 board agenda

Board agendas should continue to evolve in 2018 as the game-changing implications of technology/digital innovation, scrutiny of corporate culture, growing demands to address environmental and social issues, and investor expectations for greater board engagement and diversity and long-term performance all drive a sharper focus on positioning the company for the future. Combined with uncertainty around trade and infrastructure policies, and geopolitical tensions at precarious levels, the year ahead will require a careful balance of near-term focus, agility, and long-term thinking. Drawing on insights from our work and interactions with directors and business leaders over the past 12 months, we've highlighted six items for boards to consider as they focus on their 2018 agendas—on the critical challenges at-hand and on the road ahead.

Help the company keep its eye on the ball: long-term value creation.

One of the board's most important roles is to empower the CEO and management team to think and act long- term—investing in talent, driving innovation, and taking the long view on corporate performance. Of course, the short-term cannot be ignored—there is a genuine need for short-term stewardship but don't let it distract from focusing on the long term. The challenge for the board is to help the company align near-term activities and results with long-term value creation.[1]

Indeed, major investors (such as BlackRock, Vanguard, State Street, and others) have made clear their expectations for companies to focus on long-term value creation and the factors driving it—strategy and risk, talent, investment in research and development, culture and incentives, and, more recently, environmental, social, and governance (ESG) issues, particularly climate change and diversity. On ESG issues—which are squarely in the sights not only of investors, but also of employees, customers, and communities—the board can help management widen its aperture to understand how the company's strategy and operations impact all of its key stakeholders and drive long-term performance. (See KPMG's "ESG, Strategy, and the Long-View."[2])

> "Corporate culture—what the company does and how it does it—permeates virtually every aspect of an organization, is critical to the execution of strategy, and needs to be front and center in the boardroom."

Among the key areas of board focus: Do we have a coherent long-term strategy? How closely do our short-term actions and targets connect with that strategy? Can the management team and members of the board articulate that connection? Do current and potential shareholders have a clear understanding of the connection to help them make informed investment decisions?[3]

Expect disruption to continue full-force with technology and "digital" at its core.

The raft of start-ups upending traditional business models should put disruption high on board agendas. Advances in digital technologies such as cloud computing, robotic process automation, machine learning, artificial intelligence (AI), and blockchain are transforming how companies do business. Moreover, the speed and impact of these technologies—automating, self-learning, reshaping business processes—have the hallmarks of another "new economy" (the Internet was the last one). Help the company test its strategic assumptions and keep sight of how the big picture is changing. What disruptive trends are directors seeing in other industries?

Understanding how the company collects, protects, analyzes, and uses data has become table stakes for broader, potentially game-changing questions: What are the goals of the company's digital strategy and how can the use of big data and advanced analytics drive the business? Do we have the right tools, technology, resources, and talent to develop a quality big data program? How do we determine what information drives value for the organization, e.g., insights into customers, employees, suppliers, business processes, and emerging risks?

[1] Report of the 2015 NACD Blue Ribbon Commission: The Board and Long-Term Value Creation.

[2] KPMG Board Leadership Center, *ESG, Strategy, and the Long-View: A Framework for Board Oversight*, 2017 available at kpmg.com/us/esgframework.

[3] Ibid.

On the 2018 board agenda *continued*

Be particularly sensitive to risks posed by the tone at the top and culture throughout the organization.

As recent headlines have demonstrated, many of the crises that have caused the greatest damage to corporate reputations were driven by the conduct of and tone set by leadership, as well as the risks associated with the culture throughout the organization. The right tone at the top and culture are essential to any effective risk management program. Have a laser-like focus on the tone set by senior management and zero tolerance for conduct that is inconsistent with the company's values and ethical standards, including any "code of silence" around such conduct. Be sensitive to early warning signs and verify that the company has robust whistle-blower and other reporting mechanisms in place and that employees are not afraid to use them. Corporate culture—what the company does and how it does it—permeates virtually every aspect of an organization, is critical to the execution of strategy, and needs to be front and center in the boardroom. Understand the company's *actual* culture (the unwritten rules versus those posted on the breakroom wall); use all the tools available—surveys, internal audit, hotlines, social media, walking the halls and visiting facilities—to monitor the culture and see it in action; recognize that the tone at the top is easier to gauge than the mood in the middle and the buzz at the bottom. How does the board gain visibility into the middle and bottom levels of the organization? Do employees have the confidence to escalate bad behavior and trust it will be taken seriously? Make sure that incentive structures align with strategy and encourage the right behaviors, and take a hard look at the board's own culture for signs of groupthink or discussions that lack independence or contrarian voices.

Learn to live with cyber risk and refine boardroom discussions about cyber risk and security.

Not only is the cyber threat not going away, it is growing more sophisticated and aggressive, with implications for nearly every facet of the business. Hacks at prominent organizations punctuate the new reality that any system "on the grid" is vulnerable. Boardroom discussions should be moving from prevention to *detection, containment, and response* and to addressing cyber risk as an enterprise-wide business issue that can potentially impact strategy, compliance, product development, M&A, expansion into new geographies, and relationships with vendors, suppliers, and customers. A robust and frank boardroom dialogue is vital to making cybersecurity a core competency across the business. How often is the maturity of the company's cybersecurity risk management framework evaluated? How does the company keep up with regulatory changes and new legal requirements? Does the company stay abreast of industry practices and connect with law enforcement? Does the company have an incident readiness and response plan that has been reviewed and tested? Who leads the plan? Does the board get the information/reports it needs (cyber dashboard) to oversee cybersecurity efforts? Is there a C-suite executive who can effectively communicate with the board on cyber issues in the context of the business and in language the board understands?

Promote effective shareholder engagement, including engagement with activists.

Shareholder engagement continues to be a priority for companies as institutional investors increasingly hold boards accountable for company performance and demand greater transparency, including direct engagement with independent directors. Institutional investors expect to engage with portfolio companies—especially when there are governance concerns or when additional information is needed to make a more fully informed voting decision. Boards should request periodic updates from management about the company's engagement practices: Do we know and engage with our most significant

> "Being fully engaged in the business requires the board to plan for its own evolution by recruiting the mix of skills, perspectives, and backgrounds that align with the company's future needs."

shareholders and understand their priorities? Do we have the right people on the engagement team? What is the board's policy on meeting with investors? Which of the independent directors should be involved? And perhaps most importantly, does the company provide investors with a clear, current picture of its performance, challenges, and long-term vision?

As reflected in 2017 proxy trends, strategy, executive compensation, management performance, environmental and social initiatives, and board composition and performance will remain on investors' radar during the 2018 proxy season. Expect investors to focus on how companies are adapting their strategies in light of the uncertainties and dynamics shaping the business and risk environment in 2018—e.g., slow growth; questions around trade and infrastructure policy; the impact of technology on labor/wages; and extreme weather events. In his annual letter to CEOs,[4] BlackRock's Laurence Fink called it "imperative that companies understand these changes and adapt their strategies as necessary … as part of a constant process of understanding the landscape in which you operate … How have these changes impacted your strategy and how do you plan to pivot, if necessary, in light of the new world in which you are operating?" Having an "activist mind-set" will continue to be important for companies and boards in the year ahead. As we've seen, no company—no matter how large—is immune from shareholder activism.

Focus on building a board that is fit for purpose looking forward, recognizing that diversity and healthy turnover are key.

Being fully engaged in the business requires the board to plan for its own evolution by recruiting the mix of skills, perspectives, and backgrounds that align with the company's future needs. That said, it is clear that the world is changing faster than boards. Director turnover remains low (0.7 new directors per board annually); average director age has risen slightly in the last decade to 63; and progress on board diversity remains slow, with women in just 21 percent of board seats today and minorities in 15 percent among the top 200 largest companies.[5] That tenure-limiting mechanisms—term limits and mandatory age limits— have had limited impact is not surprising. Only 4 percent of boards have term limits for independent directors, and although 73 percent of boards have a mandatory retirement age (typically age 72+),[6] many have raised it and some expressly permit exceptions to the policy.[7]

The surge in proxy access proposals in recent years highlights investor frustration over the pace of change in boardrooms and points to the central challenge of board composition: a changing business and risk landscape (marked by competitive threats and business model disruption, technology innovations and digital changes, the Millennial effect, and global volatility) requires a proactive approach to board- building. Is there a plan to help ensure that the board serves as a strategic asset to the company? Take a hard look at the board's composition and how it assesses its effectiveness and positions the company for the future—i.e., board evaluations, skills/diversity matrix, succession planning, board and committee leadership, and ongoing director education. Consider a mix of director tenures (<5, 5–10, >10 years of service) to provide a blend of institutional memory and fresh perspectives.[8] Keep the critical value of this effort front and center: Diverse thinking drives better governance and better business decisions.

[4] BlackRock's 2017 Annual Letter to CEOs.

[5] Spencer Stuart Board Index

[6] Spencer Stuart Board Index

[7] Shearman & Sterling 2017 Corporate Governance and Executive Compensation survey.

[8] Report of the 2016 NACD Blue Ribbon Commission: Building the Strategic-Asset Board.

On the 2018 audit committee agenda

Financial reporting, compliance, and the risk and internal control environment will continue to be put to the test in 2018—by slow growth and economic uncertainty, technology advances and business model disruption, cyber risk, greater regulatory scrutiny and investor demands for transparency, as well as dramatic political swings and policy changes in the U.S., UK, and elsewhere. Focused, yet flexible agendas—exercising judgment about what does and does not belong on the committee's agenda, and when to take deep dives—will be critical. Here are some of the top items that audit committees should keep in mind as they consider and carry out their 2018 agendas:

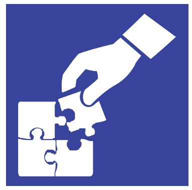
Stay focused on job No. 1—financial reporting integrity.

In our 2017 Global Audit Committee Survey, nearly half of the 800 audit committee members who responded said it is "increasingly difficult" to oversee the major risks on the audit committee's agenda in addition to the committee's core oversight responsibilities (financial reporting and related internal controls, and oversight of internal and external auditors).

Aside from any *new* agenda items, the risks that many audit committees have had on their plates for some time—cybersecurity and IT risks, supply chain and other operational risks, legal and regulatory compliance—have become more complex, as have the audit committee's core responsibilities. Reassess whether the committee has the time and expertise to oversee these other major risks. Does cyber risk require more attention at the full-board level—or perhaps the focus of a separate board committee? Is there a need for a compliance committee? Keeping the audit committee's agenda focused—and its eye on the ball—will require discipline and vigilance in 2018.

Financial reporting quality starts with the CFO and the finance organization; maintain a sharp focus on leadership and bench strength.

In our global survey, few respondents were satisfied that their agenda is properly focused on CFO succession planning or with the level of focus on talent and skills in the finance organization. Given the increasing demands on the finance organization—financial reporting and controls (including implementation of new accounting standards), risk management, analyzing mergers and acquisitions and other growth initiatives, shareholder engagement, and more—it is essential that the audit committee devote adequate time to the finance organization, including the talent pipeline, training and resources, as well as succession plans for the CFO and other key executives in the finance organization. How is the finance team incented to stay focused on the company's long-term performance? What concerns do the internal and external auditors have about the talent and skills in the finance organization, including the organization's leadership?



Monitor management's progress on implementing FASB's revenue standard and other accounting changes on the horizon, and stay apprised of tax legislative and regulatory developments.

The scope and complexity of the implementation efforts for the new FASB standards and the impact on the business, systems, controls, disclosures, and resource requirements should be a key area of focus for audit committees. The effective date of the new revenue standard—January 1, 2018, for calendar year public companies—is imminent, and implementation efforts by companies are in high gear. Given the magnitude of the implementation effort for many companies (particularly those with large, complex contracts), we recommend two broad areas of focus for audit committees. First, understand how management has determined the transition impact of adopting the new standard, which must be disclosed in the company's 2017 10-K as a Staff Accounting Bulletin (SAB) 74 transition disclosure. What has the external auditor done to evaluate the transition impact? What are the external auditor's recommendations regarding the adequacy of the SAB 74 disclosure? Second, discuss with management and understand the company's readiness to operate and report under the new standard in 2018; key areas of focus include the impact on internal control over financial reporting, the standard's new disclosure requirements, and the impact on disclosure controls and procedures. Obtain the views of the external auditor regarding the company's readiness, as the auditor is in a position to provide insights on the company's reporting processes and internal controls.

Although the new revenue standard is the primary focus for most companies, implementation of the new leases and credit impairment standards follows closely (in 2019 and 2020, respectively). SEC staff will continue to closely monitor transition disclosures for these new accounting standards, and these disclosures should be a key area of focus for audit committees. As SEC staff has emphasized, these disclosures should evolve and become more detailed as companies progress in their implementation efforts.

Finally, given the prospects for significant tax legislative and regulatory changes on the horizon—including U.S. tax reform, EU member country initiatives related to the EU Anti-Tax Avoidance Directive, and any tax developments associated with Brexit—audit committees will want to receive periodic updates from management regarding any tax legislative and regulatory developments and their impact on the company.

On the 2018 audit committee agenda *continued*

Focus internal audit on the company's key risks, beyond financial reporting and compliance.

As recent headlines demonstrate, failure to manage key risks—tone at the top, culture, legal/regulatory compliance, incentive structures, cybersecurity, data privacy, global supply chain and outsourcing risks, and environmental, social, and governance risks, etc.—can potentially damage corporate reputations and impact financial performance. The audit committee should work with the chief audit executive to help identify the risks that pose the greatest threat to the company's reputation, strategy, and operations and to help ensure that internal audit is focused on these key risks and related controls. Is the audit plan risk-based and flexible? Does it adjust to changing business and risk conditions? What has changed in the operating environment? What are the risks posed by the company's digital transformation and by the company's extended organization—sourcing, outsourcing, sales and distribution channels? Is the company sensitive to early warning signs regarding safety, product quality, and compliance? What role should internal audit play in auditing the culture of the company? Set clear expectations and help ensure that internal audit has the resources, skills, and expertise to succeed and help the chief audit executive think through the impact of digital technologies on internal audit.

Reinforce audit quality and transparency.

The need for increased transparency around the audit process—both by the auditor and the audit committee—remains in the spotlight. In October, the SEC approved the PCAOB's standard on the **auditor's reporting model**. While retaining the current pass/fail model, the new standard will require the auditor to communicate in the auditor's report critical audit matters (CAMs) arising from the current period's audit, or state in the report that the auditor determined there were no CAMs. The standard defines CAMs as matters that were communicated or required to be 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. In addition, under the new standard, the auditor's report will disclose the tenure of an auditor, state that the auditor is required to be independent, and 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.

For large accelerated filers, the requirement to communicate CAMs will be effective for audits of fiscal years ending on or after June 30, 2019; for all other companies, it will be effective for audits of fiscal years ending on or after December 15, 2020. Other requirements of the new standard are effective for audits of fiscal years ending on or after December 15, 2017. Audit committees and management should take advantage of the time before the reporting requirements for CAMs take effect to discuss the new reporting requirements with their auditors. Early dialogue will be key for effective and timely implementation of this aspect of the new standard.

There continues to be an increased focus on the audit committee's report, particularly on voluntary disclosures regarding the audit committee's oversight of the external auditor. In fact, according to the Center for Audit Quality's *2017 Audit Committee Transparency Barometer*, many audit committees are expanding their voluntary disclosures about how they oversee the external auditor. Consider expanding the audit committee's report to provide investors more insight into how the committee carries out its oversight responsibilities, particularly its role in helping to maintain audit quality.

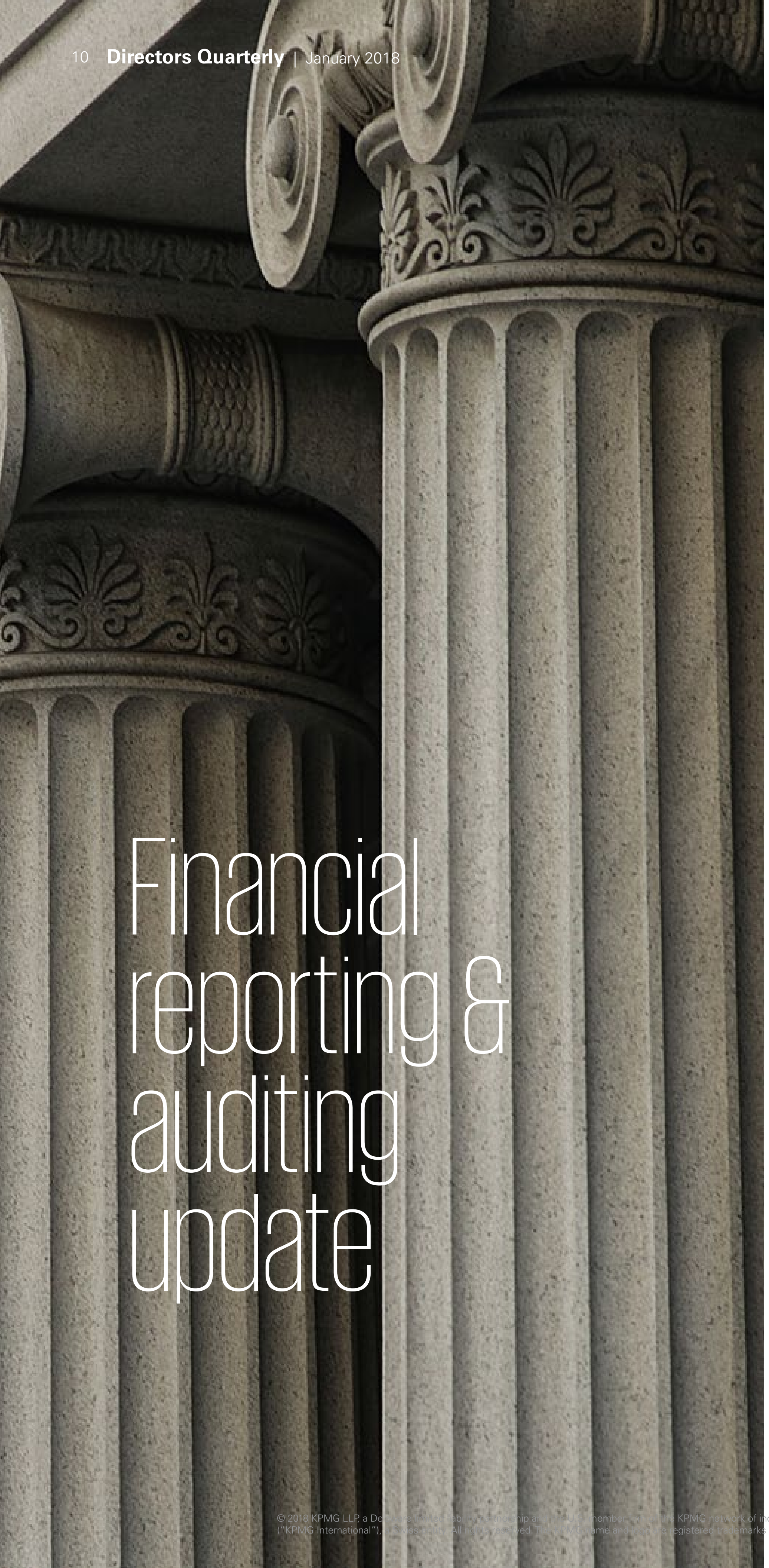
Monitor the impact of the business and regulatory environment, as well as tone at the top and corporate culture, on the company's compliance programs.

In recent years, a number of highly publicized corporate crises that have damaged company reputations were due, in part, to failures to manage key risks posed by the company's culture, tone at the top, and incentive structures. Fundamental to any effective compliance program is the right tone at the top and culture throughout the organization, including a commitment to the company's stated values, ethics, and legal/regulatory compliance. This is particularly true in a complex business environment, as companies move quickly to innovate and capitalize on opportunities in new markets, leverage new technologies and data, engage with more vendors and third parties across longer and increasingly complex supply chains, and, as a result, face heightened compliance risks.

Closely monitor the tone at the top and culture throughout the organization, and be particularly sensitive to early warning signs. Help ensure that the company's regulatory compliance and monitoring programs are up-to-date, cover all vendors in the global supply chain, and clearly communicate the company's expectations for high ethical standards. Take a fresh look at the effectiveness of the company's whistleblower program. Does the audit committee see all whistleblower complaints? If not, what is the process to filter complaints that are ultimately reported to the audit committee? As a result of the radical transparency enabled by social media, the company's culture and values, commitment to integrity and legal compliance, and brand reputation are on display as never before. Ask for internal audit's thoughts on ways to audit/assess the culture of the organization.

Make the most of the audit committee's time together—*effectiveness requires efficiency.*

As noted previously, keeping the audit committee's agenda focused on financial reporting and related internal control risk is essential to the committee's effectiveness, but meeting the workload challenge requires efficiency as well. Streamline committee meetings by insisting on quality premeeting materials (and expect premeeting materials to have been read), making use of consent agendas, and reaching a level of comfort with management and auditors so that financial reporting and compliance activities can be "process routine" (freeing up time for more substantive issues facing the business). Does the committee leverage the array of resources and perspectives necessary to support its work? Does the committee spread the workload by allocating oversight duties to each member, rather than relying on the committee chair to shoulder most of the work? Does the committee spend time with management and the auditors outside of the boardroom to get a fuller picture of the issues? Take a hard, honest look at the committee's composition, independence, and leadership. Is there a need for a fresh set of eyes? Is it time for a rotation?



Financial reporting & auditing update

The accounting and reporting impact of U.S. tax reform, highlights from the AICPA Conference, and other audit, accounting, and financial reporting developments potentially affecting your company in the current period or in the months ahead, are summarized here.

For more, see KPMG's *Quarterly Outlook*.

Current Quarter Financial Reporting Matters

U.S. Tax Reform. H.R. 1, originally known as the Tax Cuts and Jobs Act, was enacted on December 22, 2017 and is expected to significantly impact companies' accounting for and reporting of income taxes, and the related processes and controls. Tax reform contains several key provisions that may have significant financial statement effects. These effects include remeasurement of deferred taxes, recognition of liabilities for taxes on mandatory deemed repatriation and certain other foreign income, and reassessment of the realizability of deferred tax assets.

Because ASC 740 requires companies to recognize the effect of tax law changes in the period of enactment, the effects must be recognized in companies' December 2017 financial statements, even though the effective date of the law for most provisions is January 1, 2018. However, the SEC staff issued SAB 118, which will allow registrants to record provisional amounts during a 'measurement period'. The measurement period is similar to the measurement period used when accounting for business combinations. The SAB allows a company to recognize provisional amounts when it does not have the necessary information available, prepared or analyzed (including computations) in reasonable detail to complete its accounting for the change in tax law. The measurement period ends when a company has obtained, prepared and analyzed the information necessary to finalize its accounting, but cannot extend beyond one year.

The SEC's Division of Corporation Finance also issued Compliance and Disclosure Interpretation 110.02 that clarifies that the SEC staff does not believe that remeasuring a deferred tax asset to reflect the impact of a tax law change is an impairment that would trigger an obligation to file under Item 2.06 of Form 8-K. In addition, if a company concludes that a valuation allowance due to the change in tax law is necessary during the measurement period, it can rely on the Instruction to Item 2.06 and disclose the impairment, or a provisional amount for possible impairment, in its next periodic report.

For more, see KPMG's *Defining Issues*.

AICPA Conference on Current SEC and PCAOB Developments. During the AICPA Conference on Current SEC and PCAOB Developments in December, speakers discussed recent developments and initiatives in accounting, auditing and financial reporting.

The main theme of the **new SEC leadership** was supporting the U.S. public capital market by instituting regulatory changes to encourage more IPOs and foreign private issuer registrations while maintaining a high degree of investor protection. To this end, the SEC staff outlined several initiatives designed to streamline the regulatory process.

Significant time was devoted to the **new accounting standards**. With many public companies now adopting the revenue recognition standard, the SEC staff is shifting its focus away from transition disclosures to implementation issues. SEC speakers delivered important insights about how the SEC will consider judgments that companies make when applying the revenue recognition standard and, by implication, other standards, such as the leases and credit impairment standards.

In another important shift, the FASB chairman confirmed **the end of an era** by indicating that the Board will not be developing comprehensive new standards in the near term as preparers implement and investors work to understand the revenue recognition, leases and financial instruments standards.

The PCAOB discussed its new standard, which will significantly alter the **composition of the auditor's report**. The enhanced report will feature prominently in a company's SEC filings.

Another important theme of the conference was the effect that **emerging technology** will have on the financial reporting process. Many speakers cited examples, including distributed ledger technology and robotic process automation, which are expected to affect how a company gathers and stores transactional information, and how an auditor verifies the existence of that information. Additionally, the cryptocurrencies enabled by these technologies raise a host of accounting and securities laws issues.

These conference topics illustrate the enormous changes occurring in financial reporting. We observe that two fundamental practices are crucial for managing change, no matter the source. The first is **open and robust lines of communication** between the audit committee, management and independent auditor. The second is a **commitment to developing and maintaining appropriate policies, procedures and controls** that are established by management and overseen by the audit committee. These two practices will be essential as companies manage significant changes on the horizon, including U.S. tax reform.

For more information about the conference, see KPMG's *Issues and Trends: AICPA Conference on Current SEC and PCAOB Developments*.

Financial reporting and auditing update *continued*

Other 2017 Financial Reporting Reminders. In the first quarter of 2017, calendar year-end public companies were required to adopt several new accounting standards intended to simplify or clarify accounting guidance. The new accounting standards include simplifying the measurement of inventory (ASU 2015-11), presentation of deferred taxes as noncurrent (ASU 2015-17), effect of derivative contract novations on existing hedge accounting relationships (ASU 2016-05), contingent put and call options in debt instruments (ASU 2016-06), simplifying the transition to the equity method of accounting (ASU 2016-07), and improvements to employee share-based payment accounting (ASU 2016-09). Companies should also consider disclosures about all issued but not yet adopted accounting standards (i.e., SAB 74 disclosures) when preparing their 2017 financial statements.

New Standards and Guidance

SEC Staff Observations – Implementing New Accounting Standards. In a recent speech about accounting change, the SEC staff made several observations about adopting the revenue recognition, leases and credit impairment standards.

- **Now is the time** to make implementation a priority.
- **Internal controls over financial reporting** most likely will change and require time to implement.
- The SEC expects to see increasingly informative **SAB 74 transition disclosures** in the periods before adoption of the standards.
- **New required disclosures** are an important aspect of adoption and may be time consuming.
- The SEC is available for **pre-filing consultations** and will accept reasonable, thoughtful judgments.
- **Audit committees** set the tone for successful implementations and should be actively engaged.

Companies and their stakeholders should consider these observations and thoughtfully evaluate their current and planned efforts for these major standards.

Revenue Recognition. On January 1, 2018, the new revenue recognition standard became effective for public companies with a calendar year-end. Companies need to prioritize their implementation efforts to meet their first quarter filing deadlines. At this stage, companies should be addressing last-minute technical issues, drafting their disclosures, allowing sufficient time to communicate with the analyst community, and preparing to provide evidence (in the event of an SEC filing review) to show that their judgments are reasonable and that they considered alternative views.

Adopting the Lease Accounting Standard. The new lease accounting standard will be effective for public companies in 2019. Companies that have begun implementing the standard are encountering unexpected transition challenges that should give fair warning to those companies that have not yet started or are behind. A good place to start (or continue) implementation efforts is to focus on the completeness and accuracy of the 'old' lease disclosures (i.e. those required under current US GAAP). Determining the discount rate to be used for lessee operating leases is another priority.

Implementing the Credit Impairment Standard. The FASB's new credit impairment standard will be effective in 2020 for public companies. Companies should be analyzing the implications of adopting this standard and considering the adequacy of their disclosures about the expected effects of adoption. Although the standard is not effective until 2020, those companies that will be most affected by its requirements should be making significant progress toward adoption. The nature and extent of preparations will vary, but companies will need to thoroughly evaluate the effect of the standard and determine what changes will be necessary. Companies may need to collect more data, and significantly change their systems, processes and internal controls to comply with the standard.

Audit Developments

2017 Audit Committee Transparency Barometer. The Center for Audit Quality (CAQ) and Audit Analytics released their annual report that measures the robustness of proxy disclosures among companies in the S&P Composite 1500. The CAQ's findings confirmed that audit committees have continued to enhance transparency of external audit oversight by voluntarily and broadly increasing disclosure. The report also offers examples of leading disclosure practices that can be tailored to a company's specific facts and circumstances. See: *2017 Audit Committee Transparency Barometer*

SEC Approves Changes to the Auditor's Reporting Model. The SEC recently approved the PCAOB standard that requires significant enhancements to the auditor's report prepared under those standards. The first phase of the new requirements is effective for auditors' reports for fiscal years ending on or after December 15, 2017. Amendments related to interim review reports are effective for interim periods thereafter (e.g., March 31, 2018 for a calendar year-end company). Phase one enhancements include:

- disclosing auditor tenure (i.e. the year in which the auditor began consecutive service as the company's auditor);
- adding wording to clarify 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 misstatement, whether due to error or fraud;
- adding a statement that the auditor is required to be independent; and
- reorganizing the auditor's report so that the opinion will be included in the first paragraph.

The PCAOB published guidance to help audit firms implement the first phase of these changes.

Phase two requires auditors to communicate critical audit matters (CAMs) in the auditor's report. The standard defines CAMs as matters that are required to be or 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. The requirement to communicate CAMs will be effective for:

- **large accelerated filers**, for audits of fiscal years ending on or after June 30, 2019; and
- **all other companies**, for audits of fiscal years ending on or after December 15, 2020.

Management and audit committees should take advantage of the time before the CAM reporting requirements become effective to discuss the new requirements with their auditors. Early dialogue will be key for effective and timely implementation of this aspect of the new standard.

Investor Intelligence and Insights

On the 2018 investor agenda

by Stephen L. Brown

Reflecting on the events of 2017 and recent conversations with members of the institutional investor community, several high-level themes related to board operations and board leadership on environmental, social, and governance (ESG) issues are likely to be top of mind for investors this year.

Board Operations

Since the financial crisis nearly 10 years ago, investors have become increasingly attentive to why and how directors come to serve on portfolio company boards and whether directors are carrying out their duties effectively and adding value. Investors continue to scrutinize all aspects of board operations, from board skills matrices, diversity, tenure and succession processes to the efficacy of the board evaluation process.

Board diversity. Last year, the world's largest money managers announced plans to focus on board diversity and hold directors—particularly nomination and governance committee chairs—responsible for lack of progress. Boards should expect this focus to intensify; investors typically provide a de facto one-year grace period after such pronouncements. They will inquire about diversity and delve into search and succession processes. The "Boardroom Accountability Project 2.0" calls on boards to disclose the race and gender (and, optionally, sexual orientation) of their directors, along with directors' experience and skills, in a matrix format. *Are we prepared to present a convincing and credible argument that the board has the right mix of skills, backgrounds, and personalities?*

Board evaluations. Consistent with the desire to understand board performance and dynamics, shareholders are interested in understanding how boards are using the board evaluation process for self-improvement and board refreshment. *What, if anything, should we consider changing to be best-in-class? Do we have a compelling story to tell in proxy disclosures and shareholder discussions about our evaluation process?*

Corporate culture. Events of 2017 put corporate culture and tone at the top front and center. Investors will want to understand how the board keeps abreast of company culture. *Does the board understand the culture at all levels of the company? What information does the board need to gain adequate insight into human capital issues?*

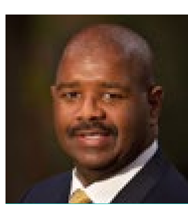
Board leadership on ESG

Recent surveys have shown that ESG is not necessarily high on the list for board and business priorities but is indeed top of mind for investors. Management and boards must prepare to bridge this gap.

Environmental. Several large institutional investors have expressed interest in gaining a deeper understanding of how companies are managing risks related to issues such as climate change. The Financial Stability Board's Task Force on Climate-Related Financial Disclosures has published recommendations for disclosure of climate-related financial risks. Also, major institutional investors have shown a willingness to use their proxy votes when they are not satisfied with the company's climate-related disclosures. In some cases, they even supported shareholder proposals calling for greater transparency. *How are we conveying the board's role in oversight of climate-related risks? Is the company prepared to answer questions about* decisions regarding disclosure frameworks?

Social. From the #metoo campaign and questions around workplace sexual harassment and gender pay equity to CEO pay ratio disclosure, the events of 2017 catapulted human capital issues to the forefront. Questions about how companies are managing these risks are on investors' agendas. *How do we effectively inform ourselves regarding the treatment of employees? Does the company have the right systems in place to provide these insights?*

Governance. While 2018 places a heightened emphasis on environmental and social concerns, governance will also be relevant given the commencement of the first stewardship code in the United States. The Investor Stewardship Group (ISG), formed by several large U.S.-based institutional investors, announced a corporate governance framework for U.S. institutional investor and boardroom conduct, effective January 2018. The framework details six principles that ISG believes are fundamental to good corporate governance. *Are we aligned with the ISG principles and do we demonstrate such alignment? If not, can we explain why?*



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

Mark your calendar

KPMG/NACD Quarterly Audit Committee Webcast
January 18

The quarterly webcast from KPMG's Audit Committee Institute and NACD will feature a discussion on the global economic outlook with Leo Abruzzese, Global Forecasting Director for The Economist Intelligence Unit, as well as a financial reporting update and an overview of current developments shaping corporate governance and board oversight.

Register at *kpmg.com/aciwebcast*.

From Battlefield to Boardroom, Washington, DC
February 21-23

This program is designed to prepare retired and soon-to-retire military flag and general officers to serve in the boardroom. Attendees will interact with experienced directors and corporate governance professionals and also offers mentorship and networking opportunities with experienced flag and general officers-turned-board members.

Request an invitation at *NACDOnline.org*.

WCD Americas Institute, Aventura, FL
March 6–8

Join WomenCorporateDirectors at the Turnberry Isle Resort in South Florida for discussions and networking on critical issues in business, leadership, innovation and governance, including featured keynotes, panels, roundtable discussion groups, and a reception bringing a diversity of perspectives together.

Learn more at *www.womencorporatedirectors.org*.

NACD Global Cyber Forum, Geneva, Switzerland
April 17-18

KPMG will join NACD and multinational directors, executives, cyber experts, global law enforcement, and other thought leaders to offer valuable insight into key cyber risk issues and practical action items that directors should implement to help defend their companies against the most critical cybersecurity issues.

Request an invitation at *NACDOnline.org*.

Selected reading

Connecting geopolitics, markets, and strategy *KPMG*

2017 Spencer Stuart U.S. board index *Spencer Stuart*

2017 Audit Committee Transparency Barometer *CAQ*

Managing tough issues in the boardroom *WCD*

Global trends in corporate responsibility reporting *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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