KPMG

Directors Quarterly

Insights from the Board Leadership Center

Jaunuary 2019

Agility and purpose

Navigating near-term challenges while staying focused on long-term performance is getting more complicated by the quarter. The stock market is not the economy, yet investor jitters—prompted by rising U.S. interest rates, recent tech stock sell-offs, a slowing Chinese economy, mounting global trade tensions, and uncertainty about Brexit—signal significant hurdles ahead. While the U.S. economy seems to be a bright spot, many economists and business leaders are questioning whether we are close to the end of the bull run. Given the pace of innovation and digital disruption, combined with rising expectations—of consumers, employees, and investors—for long-term performance, 2019 is shaping up to be a pivotal year for how business leaders think about risk, capitalize on opportunity, and position their companies for the future.

This quarter, we share the critical issues that should be front and center on board agendas, including digital disruption, CEO succession and talent development, board composition, culture, cybersecurity, data privacy, and crisis readiness. We also highlight key areas for audit committee focus. High on the list: taking a fresh look at the committee's agenda and workload; sharpening the focus on culture, ethics, and compliance; and understanding the impact of technology and data on the finance organization.

These issues and more are front and center at the KPMG Board Leadership Conference (January 7–9 in Orlando), with insights from Wharton Professor Adam Grant, former Vanguard Chairman Bill McNabb, BNSF Railroad Executive Chairman Matt Rose, Admiral James Stavridis (Ret.), former U.S. Chief Technology Officer Megan Smith, and Facebook Global Chief Diversity Officer Maxine Williams, among others.

This edition includes highlights from the AICPA conference on current SEC and PCAOB developments. We also offer insights on integrating environmental, social, and governance (ESG) issues into corporate strategy as well as recommendations for board oversight of disruptive risks based on the latest NACD Blue Ribbon Commission Report, to which KPMG contributed.

We hope you find *Directors Quarterly* helpful as you hone your board and committee agendas to respond to the risks and opportunities ahead.

Dennis T. Whalen
Leader
KPMG Board Leadership Center

What's inside

Save the date

KPMG Board Leadership Conference

January 6–8, 2020

Park Hyatt Aviara
San Diego, CA

On the 2019 board agenda

Board agendas should continue to evolve in 2019. 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, diversity, and long-term value creation should all drive a sharper focus on positioning the company for the future. Combined with concerns about mounting trade tensions, resurging debt, high valuations, and political swings in the U.S., UK, and elsewhere, 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 seven items for boards to consider as they focus their 2019 agendas on the critical challenges at hand and on the road ahead:

— Take a hard look at the board's composition: Is the talent in the boardroom diverse and aligned with the company's strategy and future needs?

— Recognize that connecting digital disruption with risk management and strategy is more important—and more challenging—than ever.

— Help focus the company on long-term value creation and understand the views of all key stakeholders.

— Make CEO succession and talent development throughout the organization a priority.

— Assess, monitor, and reinforce culture as a strategic asset and critical risk.

— Continue to refine boardroom discussions about cybersecurity and data privacy as risk management issues.

— Reassess the company's crisis prevention and readiness.

Take a hard look at the board's composition: Is the talent in the boardroom diverse and aligned with the company's strategy and future needs?

Institutional investors are increasingly focused on board composition, expressing concern about lack of diversity, low director turnover, and whether the board has the right skill sets to guide the company and its strategy in the future. While determining the company's current and future needs is the starting point for assessing and enhancing the board's composition, there is a broad range of board composition issues that require board focus and leadership—including succession planning, age and term limits, diversity, individual director evaluations, removal of underperforming directors, and board refreshment, as well as disclosures regarding these issues.

As former Vanguard Chair William McNabb wrote in a letter to public company directors last year, the board "is one of a company's most critical strategic assets," and Vanguard looks for "a high functioning, well-composed, independent, diverse, and experienced board with effective

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ongoing evaluation practices." The New York City Comptroller and the New York City Pension Funds, as part of a boardroom accountability project, sent letters to more than 150 companies in 2018 requesting disclosure of the skills, gender, race, and (optionally) sexual orientation of directors in a board matrix in the proxy. As of June 2018, 49 of the companies had elected new diverse directors, and another 24 publicly committed to include women and people of color in their candidate pool for every board search. Some large institutional investors, including BlackRock and State Street, have announced that they will vote against or withhold votes from directors—primarily nominating and governance committees—due to lack of board gender diversity. California's recently passed law requiring publicly traded companies based there to have at least one woman on their board by the end of 2019 clearly punctuates the calls for progress on diversity.

Board composition and diversity should be a key area of board focus in 2019 and a topic for communication with the company's institutional investors, including through enhanced disclosure in the company's proxy.

Recognize that connecting digital disruption with risk management and strategy is more important—and more challenging—than ever.

Advances in digital technologies such as cloud computing, robotic process automation, machine learning, artificial intelligence (AI), and blockchain—and the speed of these advances—are disrupting business models and transforming how companies do business. As discussed in the 2018 NACD Blue Ribbon Commission Report, *Adaptive Governance: Board Oversight of Disruptive Risks*, traditional enterprise risk management processes may not be designed to address the disruptive risks posed by these digital advances or to assess the continuing validity of key assumptions on which the company's strategy and business model are based. Help management reassess the company's processes for identifying the risks and opportunities posed by digital advances and for assessing their impact on the company's strategy. Does management have an effective process to monitor technology changes in the external environment? Does the process provide an early warning that adjustments to the strategy might be necessary?

Also, 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 help drive the business? Does the company 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, and business processes—and how do we manage the data in a responsible, ethical manner?

Help the company test its strategic assumptions and keep sight of how the big picture is changing by connecting dots, thinking differently, and staying agile and alert to what's happening in the world. In short, digital disruption, strategy, and risk should be hardwired together in boardroom discussions.

Help focus the company on long-term value creation and understand the views of all key stakeholders.

Major investors (Blackrock, Vanguard, State Street, and others) continue to emphasize their expectations for companies to focus on long-term value creation and the factors driving it: strategy and risk, talent, R&D investment, culture and incentives, and environmental, social, and governance (ESG) issues—particularly climate change and diversity. At the same time, these investors stress the importance of the sustainability of the company's business model.

In his 2018 letter to CEOs, BlackRock's Larry Fink expanded on this theme, emphasizing purpose and a stakeholder-focused model of governance: "Without a sense of purpose, no company, either public or private, can achieve its full potential. It will ultimately lose the license to operate from key stakeholders. It will succumb to short-term pressures to distribute earnings, and, in the process, sacrifice investments in employee development, innovation, and capital expenditures that are necessary for long-term growth. It will remain exposed to activist campaigns that articulate a clearer goal, even if the goal serves only the shortest and narrowest of objectives. And ultimately, the company will provide subpar returns to the investors who depend on it to finance their retirement, home purchases, or higher education."

Calling Fink's letter "both inspiring and blunt," William W. George, Senior Fellow, Harvard Business School, suggested that, "There should be no debate between the stakeholder value model and the advocates of creating shareholder value. Shareholder value is the result of having a clear mission and

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On the 2019 board agenda *continued*

set of values that motivate employees to serve customers. Companies that start with the mantra of 'maximizing shareholder value' ultimately destroy the very shareholder value that they are trying to create because they refuse to make the long-term investments required to create sustainable shareholder value." Martin Lipton of Wachtell Lipton said that Fink's letter "sets out the type of engagement between corporations and their shareholders that BlackRock expects in order to secure its support against activist pressure… [and] needs to be carefully considered in developing investor relations engagement practices…"

The shareholder/stakeholder debate may seem philosophical, but we believe it is a discussion every board should have, as it raises practical questions about the company's strategy and how that strategy should be communicated to investors and other stakeholders.

Make CEO succession and talent development throughout the organization a priority.

Few board responsibilities are more important than hiring and firing the CEO—a reality that continues to hit the headlines, particularly if the board is caught flat-footed. Given the complex and disruptive business and risk environment today, it is essential that the company have the right CEO in place to drive strategy, navigate risk, and create long-term value for the enterprise. The board should ensure that the company is prepared for a CEO change—both planned and unplanned.

CEO succession planning is a dynamic and ongoing process, and boards should always be thinking about developing potential candidates. Succession planning should start the day a new CEO is named. How robust are the board's succession planning processes and activities? Are succession plans in place for other key executives? Do we engage in due diligence about the "how" as well as the "what" of a candidate's job history when recruiting a new CEO or other key executive?

Closely linked to the importance of having the right CEO is having the talent required—from the top of the organization down through the ranks—to execute the company's strategy and keep it on track. Institutional investors are becoming more vocal about the importance of human capital and talent development programs and their link to strategy. We expect companies will face an increasingly difficult challenge in finding, developing, and retaining talent at all levels of the organization. Does management have a talent plan that aligns with its strategy and forecast needs for the short and long term? Which talent categories are in short supply and how will the company successfully compete for this talent? More broadly, as millennials join the workforce in large numbers and talent pools become globally diverse, is the company positioned to attract, develop, and retain top talent at all levels?

Assess, monitor, and reinforce culture as a strategic asset and critical risk.

Corporate culture is front and center for companies, shareholders, regulators, employees, and customers—as it should be for every board. Headlines of sexual harassment, price gouging, shady sales practices, and other wrongdoing—with corporate culture as the culprit—have put boards squarely in the spotlight: Where was the board? And what is it doing to fix the culture?

Given the critical role that corporate culture plays in driving a company's performance and reputation—for better or for worse—we see boards taking a more proactive approach to understanding, shaping, and assessing corporate culture. Among the messages we hear: Have a laser 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.

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

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visibility into the middle and bottom levels of the organization? Do employees have the confidence to escalate bad behavior and trust their concerns 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. Focus not only on results, but also on the behaviors driving them.

Continue to refine boardroom discussions about cyber security and data privacy as risk management issues.

Cyber threats continue to grow more sophisticated and aggressive, with implications for nearly every facet of business. Hacks at major companies punctuate the new reality that any organization on the grid is vulnerable. Boardroom discussions should be moving beyond prevention to detection, containment, and response—and to addressing cybersecurity as an enterprise-wide business issue that affects 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 helping the company learn to live with cyber risk and making cybersecurity a core competency across the business.

How frequently is the maturity of the company's cybersecurity risk management framework evaluated? How is the company keeping up with regulatory changes and new legal requirements? Is the company staying abreast of industry practices and connecting with law enforcement? Does the company have an incident readiness and response plan that has been reviewed and tested? Is the board getting the information it needs (cyber dashboard) to oversee cybersecurity efforts?

What risks do the use of big data pose, and who is responsible for making decisions about the collection and use of data? Europe's recently enacted General Data Protection Regulation and other data privacy rules such as California's Consumer Privacy Act should prompt rigorous assessments of companies' data practices. Indeed, with data privacy linked so tightly to trust and reputation, a running reality check is essential: "Just because we can doesn't mean we should."

Reassess the company's crisis prevention and readiness.

Crisis prevention and readiness has taken on increased importance and urgency for boards and management, as the list of crises that companies have found themselves facing in recent years continues to grow. Crisis prevention goes hand in hand with sound risk management—identifying and anticipating risks, and putting in place a system of controls to help prevent crises from happening and mitigate their impact when they do occur. We're clearly seeing an increased focus by boards on cultural risks as well as key operational risks across the extended global organization—e.g., supply chain and outsourcing risks, information technology and data security risks, etc. Does the board understand the company's critical operational risks? What's changed in the operating environment? Has the company experienced any control failures? Is management sensitive to early warning signs regarding safety, product quality, and compliance?

Help ensure that management is weighing a broad spectrum of what-if scenarios—from supply chains and the financial health of vendors to geopolitical risks, natural disasters, terrorist acts, and cyber threats. Is the company's crisis response plan robust and ready to go? Is the plan actively tested or war-gamed and updated as needed? Does it take into account the loss of critical infrastructure—e.g., telecommunications networks, financial systems, transportation, and energy supplies? Does it include communications protocols to keep the board apprised of events and the company's response? Of course, even the best-prepared companies will experience a crisis, but companies that respond quickly and effectively tend to weather crises better.

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On the 2019 audit committee agenda

Audit committees can expect their company's financial reporting, compliance, risk and internal control environment to be put to the test in the year ahead. Among the top challenges and pressures: long-term economic uncertainty (with concerns about mounting trade tensions, resurging debt, and market valuations), technology advances and business model disruption, cyber risk, regulatory scrutiny and investor demands for transparency, and political swings and policy changes in the U.S., UK, and elsewhere.

Drawing on insights from our interactions with audit committees and business leaders over the past 12 months, we've highlighted seven items that audit committees should keep in mind as they consider and carry out their 2019 agendas:

- Take a fresh look at the audit committee's agenda and workload.
- Sharpen the company's focus on culture, ethics, and compliance.
- Understand how the finance organization will reinvent itself and add greater value in this technology and data-driven environment.
- Monitor management's progress on implementing new FASB standards as well as SAB 118 adjustments related to U.S. tax reform.
- Discuss the new reporting requirements for critical audit matters (CAMs) with the external auditor and reinforce audit quality by setting clear expectations for the auditor.
- Give non-GAAP financial measures, other key operating metrics, and cybersecurity disclosures a prominent place on the audit committee agenda.
- Focus internal audit on the company's key risks beyond financial reporting and compliance.

Take a fresh look at the audit committee's agenda and workload.

We continue to hear from audit committee members that it is increasingly difficult to oversee the major risks on the committee's agenda in addition to its 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—cybersecurity and IT risks, supply chain and other operational risks, and legal and regulatory compliance—have become more complex, as have the 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 a separate board committee? Is there a need for a compliance or risk committee? Keeping the audit committee's agenda focused will require vigilance.

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Sharpen the company's focus on culture, ethics, and compliance.

The reputational costs of an ethics or compliance failure are higher than ever. Fundamental to an effective compliance program is the right tone at the top and culture throughout the organization—one that supports the company's strategy and commitment to its 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, and engage with more vendors and third parties across longer and increasingly complex supply chains. Closely monitor the tone at the top and culture throughout the organization with a sharp focus on behaviors, not just results. Help ensure that the company's regulatory compliance and monitoring programs are up-to-date and cover all vendors in the global supply chain and clearly communicate the company's expectations for high ethical standards. Focus on the effectiveness of the company's whistle-blower reporting channels and investigation processes through a #MeToo lens. Does the audit committee see all whistle-blower complaints and how they have been addressed? 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 its brand reputation are on display as never before.

Understand how the finance organization will reinvent itself and add greater value in this technology and data-driven environment.

Over the next two years, we expect finance functions to undergo the greatest technological transformation since the 90s and the Y2K ramp-up. This will present important opportunities for finance to reinvent itself and add greater value to the business. As audit committees oversee and help guide finance's progress in this area, we suggest several areas of focus.

First, recognizing that the bulk of finance's work involves data gathering, what are the organization's plans to leverage robotics and cloud technologies to automate as many manual activities as possible, reduce costs, and improve efficiencies? Second, how will finance use data and analytics and artificial intelligence to develop sharper predictive insights and better deployment of capital? The finance function is well-positioned to guide the company's data and analytics agenda—and to consider the implications of new transaction-related technologies, from blockchain to cryptocurrencies. As historical analysis becomes fully automated, the organization's analytics capabilities should evolve to include predictive analytics, an important opportunity to add real value. Third, as the finance function combines strong analytics and strategic capabilities with traditional financial reporting, accounting, and auditing skills, its talent and skill sets must change accordingly. Is finance attracting, developing, and retaining the talent and skills necessary to deepen its bench strength and match its evolving needs? It is essential that the audit committee devote adequate time to understand finance's transformation strategy.

Monitor management's progress on implementing new FASB standards as well as SAB 118 adjustments related to U.S. tax reform.

The scope and complexity of 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.

With calendar year-end public companies reporting under the **revenue recognition standard** for 2018, the SEC staff has expressed concern that disclosures do not sufficiently address the significant judgments companies are making about performance obligations, timing of revenue recognition, licensing arrangements, and "gross versus net" presentation. These disclosures require the attention of the audit committee in connection with the company's 2018 10-K and 2019 filings. Also, for some companies, implementation of the revenue standard involved both manual processes and enabling technology and tools. Manual work-arounds should not become permanent. Audit committees will want to help ensure that any work-arounds are automated as soon as possible.

The 2019 effective date for the **leases standard** is almost here for public companies. Companies have had the opportunity to assess the implications of the FASB's technical corrections and amendments and are shifting their focus to the broader aspects of adoption, including internal control over financial reporting and disclosures. SEC staff continues to closely monitor SAB 74 transition disclosures for the new standard. These disclosures should be a focus area for audit committees in connection with the company's 2018 10-K.

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On the 2019 audit committee agenda *continued*

The FASB's **credit impairment standard** will be effective in 2020 for public companies. Companies should be analyzing the implications of adoption and considering the adequacy of transition disclosures. While the nature and extent of preparations will vary, companies need to thoroughly evaluate the effect of the standard and determine what changes are necessary. Companies may need to collect more data and significantly change their systems, processes, and internal controls.

Finally, since the SEC staff issuance of **SAB 118**, many companies recognized provisional income tax amounts for the effects of the 2017 tax reform law and continue to adjust balances that were recorded provisionally as of December 31, 2017. Because the SAB 118 measurement period for provisional amounts cannot extend beyond one year, provisional amounts must be finalized by December 31, 2018, with the company's 2018 10-K.

Discuss the new reporting requirements for critical audit matters (CAMs) with the external auditor and reinforce audit quality by setting clear expectations.

In June 2017, the PCAOB adopted a new auditing standard to make the auditor's report more informative, by (among other things) expanding the audit report to include a discussion of CAMs that arose during the audit. The communication of CAMs is intended to provide information about audit areas that involved especially challenging, subjective, or complex auditor judgment and to explain how the auditors addressed these issues. The CAM requirements take effect for audits of fiscal years ending on or after June 30, 2019 for large accelerated filers. For all other entities for which the CAM requirements apply, the effective date is for audits of fiscal years ending on or after December 15, 2020.

Take advantage of the time before the CAM reporting requirements take effect to discuss them with the auditors. Early dialogue will be key to a smooth and timely implementation.

CAMs might include some aspect of revenue recognition and other critical accounting policies and estimates, business acquisitions and other significant unusual transactions, and intangible asset impairment charges or other areas that involve estimation uncertainty. It's important to understand the content of the CAMs in the context of the disclosures appearing in the financial statements as we would not expect the audit report to be a source of incremental factual information about the company.

Take advantage of the time before the CAM reporting requirements take effect to discuss them with the auditors. Early dialogue will be key to a smooth and timely implementation. What would the CAMs look like if you had to report them for 2017 or 2018? Ask the audit partner how the company's CAMs would compare with industry peers. Multinational companies that report "key audit matters" under International Standards on Auditing should consider those for reference. There are differences between the definitions of a CAM and a key audit matter, but the comparison is helpful. Audit committees will want to develop a protocol for the audit committee to hear, as far in advance as possible, the issues the auditor intends to communicate as CAMs, what the auditor intends to say about them, and how the auditor's statements will compare to management's disclosures regarding the same issues.

And reinforce audit quality, which is enhanced by a fully engaged audit committee that sets the tone and clear expectations for the external auditor and monitors performance through frequent, quality communications and a rigorous performance assessment. (See the Center for Audit Quality's *External Auditor Assessment Tool*.)

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Give non-GAAP financial measures, other key operating metrics, and cybersecurity disclosures a prominent place on the audit committee agenda.

Comment letters from the SEC staff continue to focus on the use of non-GAAP financial metrics in earnings releases, SEC filings, and investor presentations. Following 2016 staff guidance to help financial statement preparers and audit committees evaluate the usefulness and acceptability of non-GAAP financial information, the SEC staff sent over 150 comment letters questioning companies' use of non-GAAP financial measures, and the SEC initiated a number of enforcement actions. While the SEC staff credited companies with heeding the SEC's guidance, they have been critical of company disclosures regarding other key operating metrics.

While 2018 has seen fewer SEC comment letters on non-GAAP financial measures, the SEC remains focused on both non-GAAP financial measures as well as the use of other key operating metrics and continues to emphasize the importance of audit committee oversight in this area. In May 2018 public remarks at Baruch College, SEC Chief Accountant Wes Bricker commented on audit committee involvement in the review and presentation of non-GAAP measures and other key operating measures: "Audit committees that clearly understand non-GAAP measures presented to the public—and who take the time and effort in their financial reporting oversight role to review with management the preparation, presentation, and integrity of those metrics—are an indicator of a strong compliance and reporting culture. Audit committees can review the metrics to understand how management evaluates performance, whether the metrics are consistently prepared and presented from period to period, and the related disclosure policies. Audit committees that are not engaging in these processes should consider doing so. A demonstration of strong interest in these issues can have a positive effect on the quality of disclosure."

In February 2018, the SEC issued guidance regarding disclosures involving cybersecurity risk and incidents, and in October, the Commission released an investigative report cautioning companies to consider cyber threats when implementing internal accounting controls. The guidance and investigative report serve as reminders for companies to assess their internal accounting controls and disclosure controls and procedures in light of the current cyber risk environment.

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

As recent headlines demonstrate, failure to manage key risks—such as 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—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 help ensure that internal audit is focused on those risks and related controls. Is the audit plan risk-based and flexible enough to adjust to changing business and risk conditions? Have there been changes 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? Is internal audit helping to assess and monitor the company's culture? 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.

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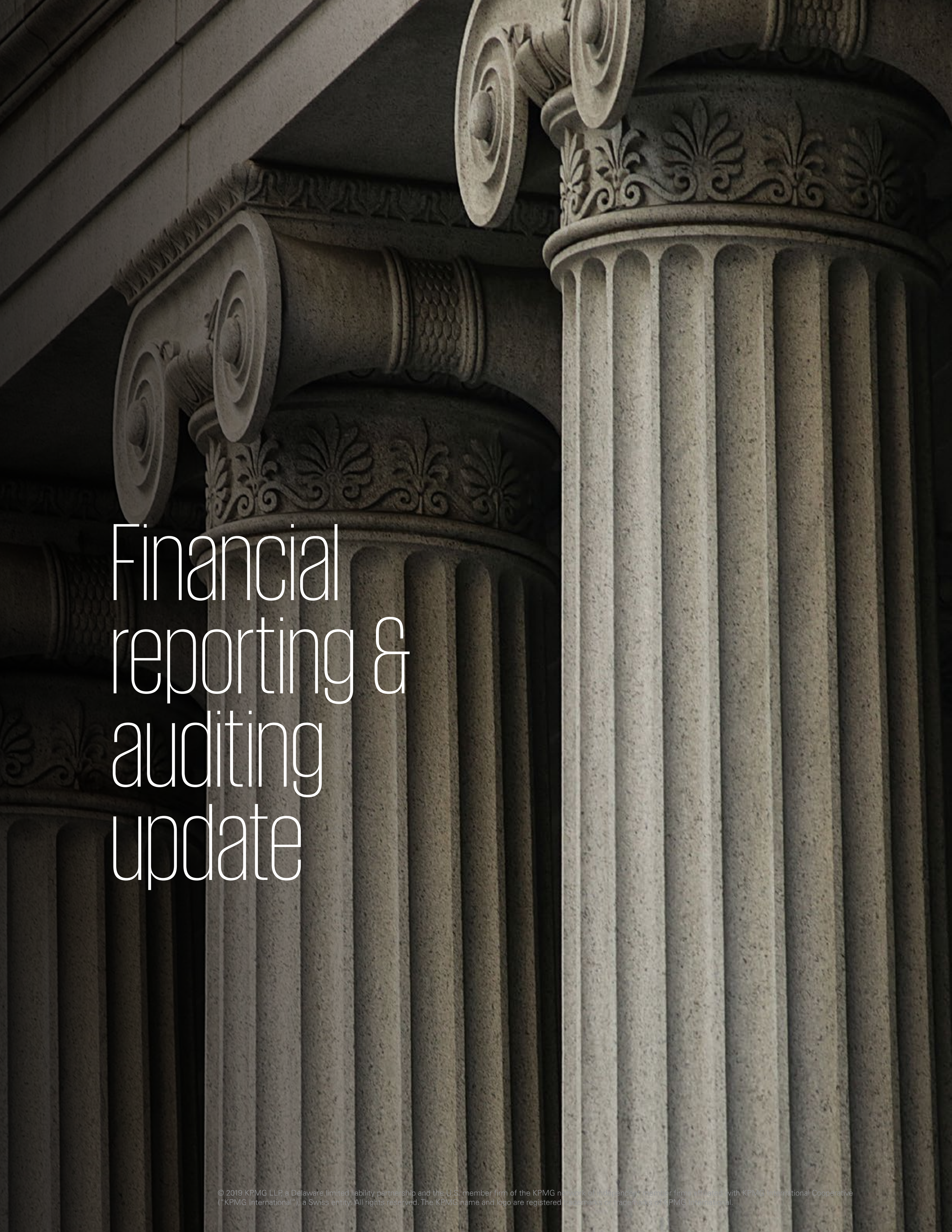

Financial reporting & auditing update

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2018 AICPA conference highlights

The AICPA held its annual Conference on Current SEC and PCAOB Developments, featuring speakers from regulators, standard setters, preparers, auditors, and others who discussed recent developments in accounting, auditing, and financial reporting. The overarching theme from SEC leadership was that high-quality financial reporting and reliable audits are a shared responsibility among all participants in the financial reporting architecture—including management, audit committees, auditors, standard setters, and regulators.

SEC Chairman Jay Clayton and Chief Accountant Wes Bricker shared the Office of the Chief Accountant's blueprint of the U.S. Financial Reporting Structure for Public Issuers, emphasizing that each participant in this architecture has a role and responsibility in preserving and advancing the quality of financial reporting for investors.

The conference devoted significant time to emerging issues, risks, and upcoming changes in financial reporting that will affect the roles and responsibilities of management, audit committees, and auditors during the 2018 calendar year-end financial reporting process and in 2019, including:

- **Preparing for new accounting standards** – Implementing the revenue recognition, leases, and credit impairment standards
- **Assessing internal controls over financial reporting (ICFR) and best practices** – ICFR in the context of implementing new accounting standards, evaluating control deficiencies, and disclosing material weaknesses
- **SEC focus areas** – Non-GAAP financial measures, the Disclosure Update and Simplification Rule, Emerging Growth Company transition issues, modification or waiver of financial statement requirements, auditor independence matters, and the SEC's 2019 rule-making agenda
- **Audit developments and their effect on financial reporting** – Audit quality and regulators' access to audit and other information internationally, the approach of the newly constituted PCAOB, and the auditor's reporting model
- **Demystifying emerging technologies** – Data analytics and initial coin offerings.

In addition, these emerging trends are expected to be hot topics for discussion between management, audit committees, and other stakeholders in the coming months.

- **Cybersecurity** – In October, the SEC issued an investigative report warning companies about cyber-related threats involving spoofed or manipulated electronic communications (email schemes). Companies should consider these threats when creating and maintaining internal controls. Earlier in the year, the SEC issued guidance on cybersecurity disclosure to assist public companies in preparing disclosures to ensure investors are sufficiently informed about material cybersecurity risks and incidents. (Also see KPMG's *SEC releases investigative report on cybersecurity frauds* and *SEC issues guidance on cybersecurity disclosures*.)
- **Brexit disclosures** – The SEC is closely monitoring how companies disclose the effect of Brexit on their business and operations. Chairman Clayton expressed concern that the potential adverse effects of Brexit are not well understood and often underestimated. He would like to see companies provide more robust disclosures about how management is considering Brexit and the effect it may have on companies and their operations.
- **LIBOR** – Banks that currently report information used to set LIBOR are expected to stop doing so after 2021. Companies face significant risks and uncertainties related to managing the transition from LIBOR to a new rate such as the Secured Overnight Financing Rate. SEC staff commented that it expects to see disclosures addressing these risks and uncertainties, if material.

For more detail about these and other issues, see KPMG's *2018 AICPA Conference on Current SEC and PCAOB Developments*.

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Navigating disruptive risk: The lead director lens

By Dennis T. Whalen

Envisioning a company's future is hard and imprecise work. But it's increasingly clear that dedicating time to think about the future is vital to navigating the disruptive risks that are shaking up industries and upending business models.

Last Fall, during the NACD Lead Director Symposium sponsored by the KPMG Board Leadership Center, we explored the topic of disruptive risks—such as technological innovation, the Internet of Things, the digital economy, demographic changes, and ecosystem changes—that may threaten the core assumptions underlying a company's strategy and business model. Approaching the topic from their perspective as board leaders, some 80 lead directors and independent chairs discussed the challenges they face as they lead their boards in helping the company identify and assess disruptive risks and as they prepare to calibrate strategy and change course as needed in an increasingly disruptive business and risk environment.

One of the important insights we heard was an articulation of the key challenge that these disruptive risks pose for boards today: obtaining a view or picture of the future and how that future may impact the company's strategy. What will the business or industry look like one, three, five, or more years from now? What will be the impact of these disruptive forces on the business or industry, and what risks will these forces pose to the company's strategy? By gaining a better understanding of the future of the business—the risks and opportunities—boards are better positioned to provide oversight and guidance on the company's key governance activities: setting and calibrating strategy, monitoring execution, and managing strategic risks.

Our dialogue with the lead directors generated a number of practical suggestions—echoing several of the recommendations made by the *Report of the NACD Blue Ribbon Commission on Adaptive Governance: Board Oversight of Disruptive Risks.*

Encourage the board, CEO, and senior management to develop an understanding of the disruptive risks that threaten the continuing viability of the assumptions underlying the company's strategy and business model. What are the most critical assumptions underlying our strategy? What disruptive forces have impacted our industry or adjacent industries, and what lessons can we learn?

Make clear that it is management's job to educate the board about these disruptive forces and the risks they pose to the company's business model and strategy. What information does the board receive from management about disruptive risks? Do their reports provide a forward-looking view of changing business conditions and potential risks? Who takes part in the discussions about disruptive risks? Are outside perspectives being heard?

Insist on an assessment of the company's ERM (enterprise risk management) processes, with a particular focus on how these processes help the company to detect and assess early-warning signals that may indicate disruptive risks on the horizon.

— Does management have regular, systemic mechanisms in place to accelerate the pace of detection of early-warning signals? Do we have people from outside, who bring very different experiences and perspectives, involved in the process?

— Do we engage expert partners to scan for subtle indicators of change, and to provide trend analyses?

— How can we enhance our risk prediction and scenario-planning capabilities?

— Do management and leadership have the talent, skills, and training to manage disruptive risks?

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With committee chairs, reassess board and committee structure and processes for overseeing disruptive risks.

— While the full board has responsibility for overseeing strategic risks—and disruptive risks are generally strategic risks—board committees have important oversight responsibilities as well. And committees can bring increased focus and attention where required. Which board committee has responsibility for overseeing each of the disruptive risks management and the board have identified as posing a threat to core strategic assumptions?

— Which committee should oversee management's ERM processes generally—and particularly the adequacy of ERM processes to help the company detect and assess early-warning signals that may indicate disruptive risks on the horizon?

— Is ample committee and board agenda time devoted to disruptive risks?

— How does the board stay abreast of company and industry developments between board meetings?

As part of the board evaluation, assess whether the board has the "right" composition and culture (in addition to the "right" structure and processes) to provide effective oversight of disruptive risks.

Gaining a better understanding of the future—and the potential impact of disruptive forces on the business and industry—won't enable the board and management to predict or prevent all disruptive risks, but it will provide greater agility and help position the organization to effectively manage and respond to disruptive risks that do arise.

This article originally appeared in the NACD BoardTalk Blog.

Adaptive governance: Board oversight of disruptive risks

KPMG's Dennis T. Whalen, Leader, Board Leadership Center, Stephen Brown, Senior Advisor, Board Leadership Center, and Kelly Watson, Leader, Risk Consulting, served among 29 Commissioners of the 2018 NACD Blue Ribbon Commission Report. Following are the recommendations of the Commission.

1. The board, CEO, and senior management need to develop an understanding of disruptive risks—those that could have an existential impact on the organization—and consider them in the context of the organization's specific circumstances, strategic assumptions, and objectives.

2. Nominating and governance committees should consider how to incorporate disruptive risks into the scope of their board's risk-oversight responsibilities at the full-board and/or key-committee levels. The allocation of responsibilities can be clarified in committee charter language.

3. Ensure that the organization's fundamental enterprise risk management processes are effective, but recognize that these processes may not necessarily capture disruptive risks.

4. On a regular basis, evaluate the culture of the board on dimensions including the level of openness to sharing concerns, potential problems, or bad news; response to mistakes; and acceptance of nontraditional points of view.

5. The board's CEO selection and evaluation processes should include assessments of his or her leadership abilities in an environment of disruptive risks.

6. Boards should ensure their organization's talent strategy reflects a proactive approach to the skills and structure needed to navigate disruptive risks.

7. Director renomination should not be a default decision.

8. Board diversity is a strategic imperative, not a compliance issue.

9. Nominating and governance committees should establish requirements for ongoing learning by all directors, and incorporate them into the board's evaluation process.

10. Ensure board-level risk reports provide forward-looking information about changing business conditions and potential risks in a format that enables productive dialogue and decision-making.

11. Establish time on the board agenda, at least annually, for a substantive discussion of the company's vulnerability to disruptive risks. Consider using approaches such as scenario planning, simulation exercises, and stress testing to inform these discussions.

The full report is available at *www.NACDonline.org*.

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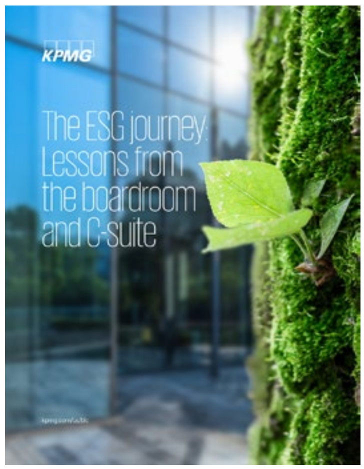
The ESG journey:
Lessons from the boardroom and C-suite

It is widely recognized that environmental, social, and governance (ESG) issues factor into corporate performance and can no longer be seen as "soft" reputational issues to be handled by public relations or marketing. Investors are increasingly aware that poor ESG practices may pose environmental, legal, and reputation risks that can damage the company and the bottom line, and that positive ESG practices can contribute to improved company performance.

The US SIF Foundation estimates that $12 trillion, or one-fourth, of all professionally managed assets in the United States incorporated ESG factors in 2017, up 38 percent in two years. And a consortium of investors representing over $5 trillion in assets under management recently petitioned the U.S. Securities and Exchange Commission to initiate rulemaking on a framework for ESG-related disclosures for public-reporting companies.

To build on our work in *ESG, strategy and the long view*, a framework for boards to help guide their companies in addressing ESG issues, the Board Leadership Center interviewed directors and officers of major corporations, including Morgan Stanley, Tyson Foods, Ford Motor, Microsoft, Mars, and Whirlpool, among others.

As we heard in those interviews, even for conscientious CEOs and boards, integrating ESG into corporate strategy isn't easy. ESG often means different things to different people. Transforming it from an ancillary issue siloed in a distant corner of the enterprise to a broad core competency requires significant, sustained effort. And there's no single model for organizations to follow. Following are select highlights from the interviews.



Q. What has been the driving force behind the company's decision to focus so intensely on these environmental, social, and governance issues?

As to the people driving ESG, "I think it is both top down and bottom up. From the top, a founder or CEO recognizes the mutuality principle and determines that the purpose of the company is to create mutuality of services and benefits for all stakeholders—shareholders, employees, customers, and suppliers. Basically, the founder or CEO believes that we can only be successful in the long term if everybody we touch is also being successful. This is core to the company's strategy; we can only be successful in the long term if we are taking care of the people in our supply chain, our customers, our employees, and the environment. So it's not altruism—it's business and it's a win-win."

"The bottom up piece comes from a number of passionate individuals who have seen the light over the past 10 or 15 years and have been working out what the mutuality principle really means for us and how we live up to our responsibilities. What is the right target for us on carbon? What is the right target for us on water? And how should we think about human rights? Talented and passionate individuals often at mid levels of management have wrestled with and grasped different pieces of this puzzle and made sense of it. And that then has led to targets and programs."

"I would identify ERM and industry disruption as two of the driving forces. ERM helps you focus on key risks of strategic importance to the company, and some of these risks are ESG-related. In effect, ERM serves as a catalyst for getting the conversation going around ESG issues. And industry disruption is what gets people thinking a lot more about trends, what's happening in society, and the need for innovation. This focus on industries experiencing a lot of disruption—such as consumer products, oil and gas, and automotive industries—forces the board and management to take a hard look at strategy and the ESG issues critical to that strategy. And so I think that the combination of ERM and industry disruption has really spurred this ESG conversation in a lot of industries."

How difficult is it to get buy-in from the board and management on ERM? "This is not altruism. This is not about doing good for the world. This is about business strategy. So you get buy-in

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when you can present a business case for the investment. And that business case is made up of cost savings, cost avoidance, growth, and reputation. In general, you're not going to get a good ROI if you only look at the first three or five years; the returns are typically in the 5- to 15-year range. So if you're guided by short-term horizons, you likely won't focus on ESG."

"One of the biggest challenges to getting buy-in on ESG is when a company is going through a major turnaround and you're focusing on day-to-day survival. Many ESG issues tend to be more long term in nature. When a company is in survival mode, the short term becomes more of the focus and some long term issues such as ESG take a back seat. There are times in a company's history when certain ESG issues do need to take a back seat to short-term day-to-day survival issues."

Q. How did the board and senior management determine which environmental, social, and governance issues to focus on? Was it obvious or was there a significant effort to identify issues that were of strategic significance?

"Once the material ESG issues are identified, they become an accepted part of the metrics and scorecards. But the highly strategic ESG issues will also become part of strategy and risk discussions. You need to clearly understand your most important strategic vulnerabilities, and if you don't, an activist or analyst will. Increasingly embedded in ESG, depending on the industry, are highly strategic issues. And they deserve far more agenda time, whether it's climate change if you are an energy company or talent management if you are a service business."

"And it's not always so clear what the critical strategic issue is. When we started on the ESG journey at my company, we wanted to better understand our carbon footprint, which we thought was our truck fleet. But when we mapped it out, it wasn't the truck fleet but was power consumption in electronic devices we deployed in homes. That changed the whole discussion. But again, it's all so dynamic. Things that weren't strategic before all of a sudden become strategic."

"ESG issues are not static—they evolve. And if you look at our sustainability committee agendas, you will find that it's been a totally evolutionary process. The implications of climate change for our strategy, including fuel efficiency and our carbon footprint, have been on the board and committee agendas for some time. But with industry disruption, the agendas have evolved to include the impact of new technologies on human capital and skill set needs and the need for innovation."

"I think you have to parse ESG. For most boards, the G, or governance, is handled by the nominating/governance committee and the committee should have a pretty clear idea of what best practices are and where they're coming up short from a governance benchmarking standpoint. As to the E, or environmental issues, in some industries this is highly strategic and a key priority for management and the board. For companies in industries where it's not so strategic, it's pretty easy to identify material environmental issues and benchmark your progress. The Sustainability Accounting Standards Board (SASB) and other standard setters have provided good guidance. So, at most companies, the E gets addressed."

"But I think the one wild card is the S or social, and that is difficult for most companies. What do you mean by social? Does it include culture and talent management? What do your employees and customers think it means? Is it your profile on social media? The boards of some of the social media companies probably had a different view of the S issues two or three years ago than they do today. And with artificial intelligence and big data, the privacy and other social issues are going to increase in importance in the coming years."

"I think boards have to do a better job and be better educated about how to think about the social piece of ESG because it is going to be more and more important. And more and more happens on social media. How good are we at monitoring social media and figuring out what to do about it? Social media is a whole new area that deserves and warrants more understanding and discussion and focus by boards."

Find the full report at www.kpmg.com/us/blc

22% **of directors surveyed by KPMG** at the 2018 NACD Global Board Leaders' Summit **said ESG is directly linked to corporate strategy.**

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Mark your calendar

KPMG/NACD Quarterly Audit Committee Webcast
January 17

The quarterly webcast from the KPMG Audit Committee Institute and NACD will feature a discussion on the global economic outlook with Leo Abruzzese, Global Director of Public Policy 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 *www.kpmg.com/us/aciwebcast.*

NACD From Battlefield to Boardroom, Washington, DC
February 20–22

Join KPMG at NACD's board development program designed to prepare retired and soon-to-retire military flag and general officers for boardroom service. Topics range from boardroom basics to more complex issues of strategy, oversight and stakeholder management.

Request an invitation at *www.NACDonline.org.*

WCD Asia Pacific Institute, Tokyo, Japan
February 21–22

Corporate directors from around the world are invited to join their peers at a pre-Institute networking reception and dinner followed by a full day of programming.

For more information, visit *www.womencorporatedirectors.org.*

**WCD Global Institute,
Palo Alto, CA**
May 19–22

This annual event will include WCD's Family Business Institute, breakout sessions, panel discussions, and networking opportunities.

For more information, visit *www.womencorporatedirectors.org.*

Selected reading

2018 U.S. Spencer Stuart Board Index *Spencer Stuart*

Women in the Workplace 2018 *McKinsey & Co.*

Regional Risks for Doing Business *World Economic Forum*

Next generation audit *KPMG LLP*

Ten key regulatory challenges of 2019 *KPMG LLP*

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

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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/us/blc*.

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