KPMG

Directors Quarterly

Insights from the Board Leadership Center

July 2019

Geo-tensions, tech, and top investor concerns

While trade tensions and debate about a Fed interest rate cut are fueling uncertainty and tempering optimism, U.S. economic growth has been steady and the labor market remains strong. The majority of U.S. chief executives have a positive outlook, according to KPMG's annual CEO survey. Still, given the risks and uncertainty that companies are facing today—Brexit, trade, China's economic challenges, heightened geopolitical tensions, and more—it's important that boards frame their agendas to help ensure that the company is closely monitoring and assessing the potential impact of these risks on the company's strategy and operations.

This quarter, Eurasia Group's Ian Bremmer shares his view of the current geopolitical landscape and what it means for boards—the first in a recurring series. We also look at considerations for boards as they oversee their company's adoption of transformational technologies such as the Internet of Things, robotic process automation, artificial intelligence, and blockchain.

In this edition, we also provide an update on the financial reporting issues that audit committees should be focusing on in the near term, along with results of our latest pulse survey, which highlights the challenges and priorities that are high on audit committee agendas. We detail investor efforts to engage collectively with companies on governance and public policy issues, and we recap the topics that shareholders asked boards to address this proxy season. Finally, we share recommendations for advancing board diversity from our work with the WomenCorporateDirectors Foundation.

Enjoy the summer months and remember to mark your calendar for our annual Board Leadership Conference on January 6–8 in San Diego.

Dennis T. Whalen
Leader
KPMG Board Leadership Center

Save the date

KPMG Board Leadership Conference
January 6–8, 2020
Park Hyatt Aviara
San Diego, CA

What's inside

A geopolitical lens

by Ian Bremmer, President, Eurasia Group

Hey folks, Ian here. Happy to give you my take on the world and what it means for directors. Will be coming to you quarterly so going to address three elements in each edition—the current geopolitical course and speed, what's driving that, and the issues you might want to look out for between updates.

What's our current (geo)political trajectory?

I've been asked a lot lately if trade wars and geopolitics are leading us into an economic recession. That's not my base case, but I do think that tail risks which could spark an economic meltdown are growing. That's true for trade, like the numerous international confrontations with the United States (China and Mexico most clearly, but also potential U.S. tariffs on the EU and Japan) or Brexit (and, indeed, a no-deal Brexit). Tail risks are also growing on military conflicts in geopolitical hotspots, like Iran and North Korea, or between military rivals in proxy wars, like the United States and Russia over Venezuela, or between Turkey and Russia (or Turkey and the United States, or the United States and Russia...) over Syria.

Although these risks are growing, they're also generally overstated. We've seen quick climbdowns from escalatory rhetoric on a number of issues, as the costs of actual conflict became clear and institutional backstops kick in. The U.S. and Mexico reached a quick 'deal' on migrants-for-tariffs in the face of strong Republican and cabinet opposition to tariffs in the U.S. and strong incentives for the Mexicans to relent. The fire-and-fury bluster on North Korea died down quicker than most expected because strong institutional forces were generally underestimated; in the United States, among its allies, in China (North Korea's principle supporter), and likely, though less knowable, even around Kim Jong-un. It's also true for Iran, where I've consistently maintained that the risk of direct military conflict is low, even with Iran violating some terms of the nuclear agreement. Yes, Iran's under massive economic pressure and there are elements of the U.S. cabinet pushing for a maximum pressure strategy. But the Iranians really don't want to give their enemies an excuse to attack (so their moves towards breaking the nuclear deal are cautious and incremental), while President Trump has since offered to talk with Tehran "without preconditions."

To be sure, when you add all these tail risks together, it's likely that one or two of them eventually "hit." Given the nature of these risks, if I were a director, I'd be looking to see if the executive team is doing scenario planning and stress testing, rather than hedging or divestment. Aside from these tail risks, there are two other structural trends in geopolitics that I'm more concerned about because they impact business planning and oversight even more.

The first is the deterioration of international governance. Support for global rule-making and enforcing bodies has fallen dramatically in the last few years. That manifests itself in all sorts of ways; greater budgetary pressure on the United Nations, greater fragmentation inside the European parliament, less functionality of the World Trade Organization, the U.S. withdrawal from agreements—the Intermediate-Range Nuclear Forces (INF) Treaty with Russia; the Trans-Pacific Partnership (TPP); the Paris climate agreement; the Human Rights Council. When institutional governance deteriorates, policymaking is more transactional, and that's bad for business planning. When leaders don't view alliances as strategic, they're more willing to undermine existing ones (the Turks buying military equipment from the Russians thus undermining NATO, the Brits refusing to side with the Americans on Huawei, the Italians joining China's Belt-and-Road Initiative) and less willing to form new agreements (we're nowhere close to a global approach on the ethics of artificial intelligence or coordination on quantum computing or arguably climate change). This means less efficient operating environments, more friction in doing business globally, and harder to plan more than a couple years out. Ultimately, a decline in global governance increases volatility and should lead to a "risk off" investment tilt, away from growth and towards stability.

The second structural trend—and arguably the most important change in the political risk environment in the last decade—is the reduced ability of the international system to effectively respond to major shocks when they occur. Yes, we've had Brexit, a wave of populism and nationalism across virtually every major economy, and increased authoritarianism, but no truly global crisis that required a coordinated response (like say, the 2008 financial crash or 9/11) and most importantly, economic conditions have been generally good. Hard to say what the next crisis will be (I'm most concerned about the consequences of a cyberattack—most likely Russian, but potentially from a nonstate actor—on critical infrastructure that isn't easily contained, especially on a major, say, European economy), but when it comes, the cracks in the global order are going to fail to contain the fall-out. And that's the hardest to game out economically—absent knowledge of what or when the next crisis is going to be, planning against reduced resilience is something few executive teams are prepared to do. But understanding how to shorten supply chains, reduce fixed costs, decrease reliance on potentially distressed or suddenly hostile partnerships, and related decisions are all important exercises in this environment.

This band of leaders by and large don't act in direct concert and don't salute a common flag, but their actions in aggregate have sped up the erosion of the international system and have an increasingly disruptive effect on the global order.

What's driving the current trend(s)?

I wrote in 2011 that we had entered a G-zero world (as opposed to a G-8 or G-20)—a world with no global leadership. That was driven by a number of trends that have since accelerated and led us to the geopolitical recession we're experiencing today. These include a U.S. with less interest in assuming leadership responsibilities; U.S. allies, particularly in Europe, that are weaker and looking to hedge bets on U.S. intentions; and two frenemies, Russia and China, seeking to assert themselves as (limited) alternatives to the U.S.—Russia primarily on the security front in its extended backyard, and China primarily on the economic front, regionally, and, increasingly, globally.

The roots of G-zero are structural, but its current course and speed are determined by the actions of key leaders unwilling to uphold the global liberal order, with some even bent on bringing it down. I'd certainly cast Trump and his America-first posture in this category, but others in this 'coalition of the unwilling' include Italy's Matteo Salvini, Brazil's Jair Bolsonaro, Russia's Vladimir Putin, Turkey's Recep Erdogan, Saudi Arabia's Mohammed bin Salman, Israel's Benjamin Netanyahu (for now anyway) and even North Korea's Kim Jong-un. This band of leaders by and large don't act in direct concert and don't salute a common flag, but their actions in aggregate have sped up the erosion of the international system and have an increasingly disruptive effect on the global order. And most of them aren't going away anytime soon.

What should you watch out for in the next quarter?

Much of what I've said is structural and long-term in nature, which I hope is helpful for long-term business planning and analysis. To that end, here are some quick hits on key geopolitical events in the next few months to watch out for. On U.S.–China, the G20 meeting in Osaka produced a cease fire; both sides have taken a step back from further escalation (on trade). This will bring the U.S. and China back to the negotiating table and likely keep further tariffs at bay, although somewhat counter-intuitively, might delay the lifting of current tariffs as both sides try to resolve fundamental differences without a hard deadline to reach conclusion.

However, expect little break in technology and geopolitical tensions in the short to medium term as difficult questions over Huawei and other Chinese technology champions become enmeshed with trade and make a stable, let alone cooperative relationship between the two sides ever harder to achieve. Across the Atlantic, worth paying attention to the next UK prime minister, more for signals of where the UK is headed domestically than on Brexit (since whoever wins will inevitably have to negotiate another extension with the EU past the October deadline and still face the same constraints on the deal on-offer from the Europeans.) Elsewhere in Europe, wouldn't be surprised if both the German and Italian ruling coalitions have broken down by the fall. And major developing economies generally trending positive—Bolsonaro is likely to have pension reform approved in Brazil (although with lower total savings than the initial proposal), a compromise cabinet in South Africa under Ramaphosa starting to reverse nearly a decade of freefall under Zuma (but expect a strong fightback from the Zuma state capturists), and a Modi 2.0 in India with a strong mandate for further reform (although don't expect big-bang measures of the first term like demonetisation).

Feel free to write to me, bremmer@eurasiagroup.net, if you want to go deeper on any of this or talk about a topic I didn't have space to cover.

The views and opinions expressed herein are those of the author and do not necessarily represent the views and opinions of KPMG LLP.

2019 U.S. CEO Outlook

Agility or irrelevance? A majority of the 400 U.S. CEOs surveyed by KPMG LLP this year said that being too slow can lead to obsolescence, a marked increase from those who thought so last year. What has changed? The answer is clear: The speed of change is only getting faster.

"As CEOs are embarking on aggressive, mostly inorganic growth, they need to bear in mind that resilience means being able to change at the right speed—and in such a way that the company endures," said KPMG U.S. Chairman and CEO Lynne Doughtie.

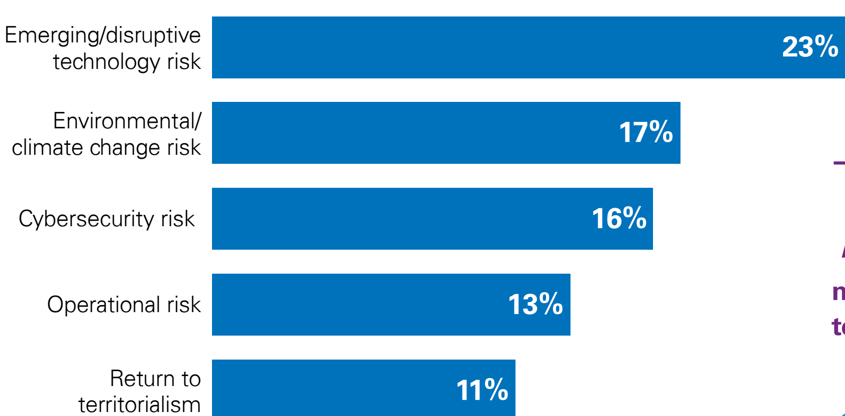
Building a resilient company rests on the foundation of innovation, and not simply doing things faster. It is crucial for resilience to comprehensively encompass all relevant areas of the organization: its technology and its people, equally.

Among the survey's key findings:

- U.S. CEOs are more positive about the economic outlook for the next three years than all other CEOs in KPMG's global survey and 81 percent plan to pursue inorganic growth, favoring strategic alliances and M&A.
- 89 percent of CEOs surveyed feel that they are personally responsible for leading technology strategies in their organizations, but have extended the time they expect to see a significant return on investment from artificial intelligence.
- U.S. CEOs view cyber risk as part of technology risk and 44 percent of those who consider emerging or disruptive technologies as the greatest risk to their organization's growth classify cyber security risk as its cause.
- Agility has emerged as a critical capability: 68 percent of U.S. CEOs believe that being too slow can lead to obsolescence and 63 percent agreed that they need to improve their innovation process and execution over the next three years.
- 77 percent of U.S. CEOs believe that they could further improve their understanding of their customers and 81 percent feel that it is their responsibility to ensure that their organization's environmental, social, and governance policies reflect the values of their customers.

For more insights from the 2019 U.S. CEO Outlook, visit *kpmg.com/us/ceooutlook*.

Which of the following risks pose the greatest threat to your organization's growth?



73% of U.S. CEOs surveyed believe that AI and robotics will create more jobs than they eliminate, compared to 52% last year

68% of U.S. CEOs consider their companies prepared for a cyber attack, compared with 77% last year

Top 10 transformational technologies

The Internet of Things (IoT)—from wearable health monitors to connected homes and cities—is viewed as the top driver of business transformation over the next three years, according to KPMG's 2019 Technology Industry Innovation Survey.

Robotic process automation (RPA)—which comprises the software bots that facilitate the automation of manual and structured activities—ranked second, up from ninth last year, followed by artificial intelligence. Blockchain jumped to fourth place on the list, up from seventh, with financial services, industrial manufacturing, and telecommunications firms expecting to have the greatest adoption over the next three years.

Business leaders cite improved business efficiencies, increased profitability, and cost reductions as the top benefits of adopting transformational technologies. For several of the technologies, however, respondents were skeptical of the business case or had concerns regarding technology complexity and security.

As companies look to invest in business transformation through technology, boards should understand management's approach to the following:

Assessing how transformative technologies and new competitors may impact different aspects of your business model including value proposition, key stakeholders, workforce, current processes, and legacy technologies.

Prioritizing the capital allocation for adoption of new technologies that will be instrumental in creating sustainable long-term value.

Engaging in strategic M&A and partnerships to accelerate implementation of transformative technologies.

Ensuring your business model is adaptable to harness new technologies and build an operational ecosystem around them.

Fostering a corporate culture that embraces innovation, agility, and experimentation.

Exploring adoption of transformative technologies that millennials are comfortable with. As the largest contingent of the future global workforce, they are positioned to create competitive advantages by leveraging these technologies.

For more, visit *kpmg.com*.

The ranking

Responses to the 2019 Technology Industry Innovation Survey yielded the following top ten list of technologies that are perceived by technology industry leaders as having the greatest potential to drive future business transformation and long-term value.

Technology	2019 Rank	2018 Rank
Internet of Things (IoT)	1	1
Robotic process automation (RPA, e.g. software bots)	2 ◀◀◀	9
Artificial intelligence, cognitive computing, machine learning	3	2
Blockchain	4 (tie) ◀◀◀	7
Robotics and automation (including autonomous vehicles)	4 (tie)	3
Augmented reality	6	8
Virtual reality	7	4
Social networking, collaboration technologies	8	5
Biotech, digital health, genetics	9	6
On Demand marketplace platforms	10	10

Largest jump in ranking: ◀◀◀

Source: KPMG Technology Industry Innovation Survey 2019

Financial reporting and auditing update

Current quarter financial reporting matters

Leases: Adoption-year reminders. Calendar year-end public companies were required to adopt the new leases standard (ASC 842) in the first quarter of 2019. All other public companies are required to adopt the standard on the first day of their fiscal year that begins during 2019, and private companies are required to adopt the standard in 2020.

Regardless of whether they have adopted ASC 842, many companies are still implementing new IT systems and processes to extract the lease data needed to comply with the new accounting and disclosure requirements. In addition, many companies still have accounting questions in these significant areas—including identifying embedded leases, determining the lease term, and determining the lessee discount rate for the lease.

Many companies that have recently adopted the standard also are adjusting their existing IT systems and lease accounting processes to sustainable end-states capable of addressing the ongoing requirements of ASC 842, e.g., identifying and accounting for lease modifications and reassessments. Companies that have not yet adopted the standard are encountering many of the same challenges.

Under Regulation S-X, SEC registrants are required to provide the annual and interim disclosures required by a new accounting standard in each quarterly report in the year of adoption, i.e., for ASC 842, the first, second, and third quarter Form 10-Q filings during 2019.

The effective date of CAMs is here. Implementation of Phase 2 of PCAOB AS 3101 regarding communication of critical audit matters (CAMs) by auditors is effective for fiscal years ending on or after June 30, 2019, for audits of large accelerated filers, and for fiscal years ending on or after December 15, 2020, for audits of all other companies for which the requirements apply.

The external auditor's 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 PCAOB expects that in most audits, the auditor will identify at least one CAM. However, in the infrequent circumstance in which no CAMs are identified, the auditor is required to state that in the auditor's report.

Ongoing engagement between the auditor, management, and the audit committee will be key to successfully implementing the CAM requirements. Management and the audit committee should talk with their auditor about potential CAMs, including how the specific matters and related descriptions compare with information that the company already discloses.

It is not expected that the auditor would provide information in its report about the company that has not been made publicly available by the company, unless that information is necessary to describe the principal considerations in concluding that a matter was a CAM and how it was addressed in the audit.

The PCAOB recently published new guidance on the auditor's communication of CAMs. The guidance includes new FAQs related to how auditors should describe their principal considerations in determining CAMs, how they should describe audit procedures and the outcome of audit procedures, as well as the relationship between CAMs and company disclosures and the treatment of recurring CAMs.

Brexit disclosures. The deadline for the United Kingdom to withdraw from the European Union has now been extended to October 31; however, the UK may leave the EU at an earlier date if the parties can ratify a withdrawal agreement. Because the political and economic uncertainty from Brexit is significant and far reaching, the SEC staff is closely monitoring how companies—particularly those with operations in the UK or EU, or with operations that link to the UK—disclose the effect that Brexit may have on their business operations. In addition to risk factor disclosures in Form 10-K or Form 10-Q, companies should consider whether Brexit-related economic uncertainties and market volatility will significantly affect accounting estimates and financial reporting. Companies should monitor the status of Brexit for changes that may require them to revise risk factors, or other disclosures, in their 2019 quarterly reports.

LIBOR disclosures. Banks that currently report information used to set LIBOR are expected to stop doing so after 2021. Efforts to transition away from LIBOR as a benchmark reference for short-term interest rates have been ongoing and the SEC staff has been attentive to the related accounting considerations. Banks may face significant risks and uncertainties in managing the transition from LIBOR to a new rate such as the Secured Overnight Financing Rate (SOFR). The SEC staff has commented that it expects to see disclosures addressing these risks and uncertainties, if material. Separately, the FASB has a project to address the effects on financial reporting of the migration away from LIBOR to alternative reference rates.

New standards and guidance

Amendments to the credit losses standard. The FASB has been devoting attention to its financial instruments projects, particularly on finalizing amendments to the credit losses standard (ASU 2016-13), which becomes effective January 1, 2020, for many public companies. The new credit losses standard will fundamentally change how companies account for credit losses.

Targeted transition relief ASU 2019-05 allows companies to irrevocably elect the fair value option for existing financial assets on an instrument-by-instrument basis on adoption of ASU 2016-13. Except for existing held-to-maturity debt securities, the alternative is available for all instruments in the scope of ASC 326-20 that are eligible for the fair value option in ASC 825-10. If a company elects the fair value option, it will recognize as a cumulative-effect adjustment the difference between the fair value of the instrument and its carrying amount.

Changes to the guidance on estimating expected credit losses ASU 2019-04 makes targeted improvements to the Codification as it relates to financial instruments, specifically, credit losses (ASC 326), hedge accounting (ASC 815), and recognition and measurement (ASC 825). The amendments to ASC 326 are the most significant and address how a company considers recoveries and extension options when estimating expected credit losses.

Because of these changes, companies will likely need to develop new processes and internal controls to:

- Monitor financial assets, including those that were fully written off in earlier periods, for potential recoveries;
- Capture historical information about recoveries;
- Identify whether contracts contain contractual extension or renewal options that are not unconditionally cancellable by the company;
- Capture the information necessary to estimate the likelihood that extension or renewal options will be exercised, including the likelihood that contingent events will occur; and
- Measure the effect of the potential extension period on the estimate of expected credit losses.

The amendments affect companies that hold financial assets measured at amortized cost (excluding available-for-sale debt securities), particularly lending portfolios.

SAB 74 disclosure reminders As public companies gear their efforts toward implementing the credit losses standard, they must ensure that they satisfy the disclosures required under SAB 74, which requires public companies to disclose the potential effects of adopting an accounting standard before it is adopted, unless the effects are not expected to be material. Companies should consider disclosing qualitative and quantitative information and indicate their progress toward implementation. If a company cannot reasonably estimate the effect, it should consider providing additional qualitative disclosures, including a description of the effect of the accounting policies that the company expects to apply, if determined, and a comparison with its current accounting policies.

The Center for Audit Quality (CAQ) has released a tool which provides audit committees information to consider as they oversee implementation of the credit losses standard.

For more detail about these and other issues, see KPMG's *Quarterly Outlook*.

Keeping pace with disruptive risk, digital transformation

Audit committee members continue to express confidence in their oversight of core responsibilities. Yet, based on results from the 2019 KPMG Audit Committee Institute survey of more than 200 U.S. audit committee members, technological innovation, digital disruption, and the complexity of business are sharpening the audit committee's focus on risk management and the internal control environment.

Among the key takeaways from the survey:

Helping ensure that the finance organization has the talent and skills to maintain quality financial reporting is one of the audit committee's greatest challenges. Nearly three-quarters of respondents reported that their committees are discussing how the finance organization's talent, skills, and leadership must evolve to support the organization's analytics and strategic capabilities. Some 40 percent said that they are discussing finance's plans to use data and analytics and artificial intelligence to develop sharper predictive insights, and 27 percent are discussing plans to leverage robotics and cloud technologies to automate manual activities in the finance organization.

Cybersecurity continues to be a top concern. Aside from "core" financial reporting issues, cybersecurity ranked highest in terms of other top priorities on audit committee agendas. Vulnerability from third parties and the supply chain, keeping technology systems up to date, internal people risk, and—particularly concerning—talent/expertise, were cited as critical challenges.

Few are confident that their company's current enterprise risk management processes capture "disruptive risks." Just over one-third of audit committee members are confident that their company's ERM processes are robust and capture disruptive risks such as digital and technology risks. Another 38 percent said that their company's ERM processes are generally robust but may not capture disruptive risks such as digital and technology risks. One-quarter reported that their company's ERM processes require substantial work or are in the developmental stages.

Internal audit can maximize its value by maintaining flexibility to adjust the audit plan in response to changing business and risk conditions. Of those companies that reported having an internal audit function, focusing the audit plan on key areas of risk beyond financial reporting risk such as cybersecurity, information technology, and other operational risks, and maintaining flexibility to adjust the audit plan in response to changing business and risk conditions ranked as the most important ways to maximize internal audit's value. More than a quarter of respondents also suggested that internal audit add culture considerations to existing audits or undertake a stand-alone culture audit.

Few audit committee members say that companies should continue to provide quarterly earnings guidance. In fact, 34 percent said the practice of providing earnings guidance should be phased out, and 20 percent said guidance should be provided only annually. Interestingly, however, only 21 percent of audit committee members view environmental, governance, and social (ESG) issues as important to long-term performance and value creation; and nearly half view ESG as part of normal risk and regulatory compliance activities.

Find the full survey results and highlights at *kpmg.com/acisurvey*.

What boards should know about engaging with investor coalitions

by Annalisa Barrett

Expectations for directors to engage with investors have increased significantly in recent years. Many companies reach out to their largest shareholders to schedule engagement meetings well before proxy season. But rather than meeting individually with companies, some institutional investors are forming coalitions to engage collectively on specific governance issues, such as board diversity, and on public policy issues, such as climate change and the opioid crisis.

Coalition members often include a range of institutional investors, including public pension funds, union funds, foundations, asset managers, the offices of state and city treasurers and comptrollers, faith-based funds, and socially responsible investment funds. While some coalitions focus on companies in one industry or geography, others engage with broader groups of companies.

Directors should be aware of the issues that these investor coalitions are addressing in order to anticipate whether their companies may be targets of their requests, and, if so, to proactively plan for engagement with these groups.

Board diversity

Main requests:

- Increase the number of women and other diverse directors serving on U.S. corporate boards
- Include diverse candidates in director search pools

Several investor coalitions encourage their portfolio companies to increase the number of diverse directors on their boards. While the original focus of these coalitions was increasing the number of women, several have expanded their efforts to address additional aspects of diversity, such as race and ethnic background. Many of these coalitions engage with companies in specific geographic regions, while a few are targeted at companies across the country.

One of the most influential diversity-focused investor coalitions in the U.S. is the Thirty Percent Coalition's Institutional Investor group, which includes institutional investors, asset managers and owners with more than $5 trillion in assets under management. The Coalition's institutional investors "believe that diversity, inclusive of gender, race, and ethnicity, is critical to an effective board and a dimension of sound corporate governance."[1] Charlotte Laurent-Ottomane, the coalition's executive director, explains that "[t]he Coalition membership is committed to achieving diversity across industries, in senior leadership and in the corporate boardroom, which we believe should represent the gender, racial and ethnic makeup of the U.S."[2] Their institutional-investor members work together to contact boards lacking gender diversity via letters asking for engagement meetings with coalition members. In several circumstances, boards that did not respond to such requests have faced shareholder proposals on board diversity topics filed by coalition members. As an example of the coalition's impact, close to 300 companies appointed a woman to their board for the first time following the group's "Adopt a Company" campaign.

While the Thirty Percent Coalition focuses on companies across the U.S., another diversity-focused coalition has used a similar approach to engage with companies headquartered in California. The California Board Diversity Initiative, which includes public pension and university funds, engages companies headquartered in California with no women on their boards. In October 2018, the group sent letters to 91 companies requesting that they cast a wide net to identify qualified diverse directors and improve their board diversity. During the ensuing nine months, 52 companies appointed 59 women to their boards.

Another geographically focused coalition takes a slightly different approach. The Midwest Investor Diversity Initiative—which includes public pension funds, foundations, and other institutional investors in the Midwestern region of the U.S.—requests that companies headquartered in six Midwest states adopt board recruitment policies which focus on board diversity. The group calls on boards to adopt a policy requiring the inclusion of females and minorities in the candidate pool for every director search the board undertakes. "[B]y joining together as institutional investors with a regional presence and interest, the Midwest Diversity Initiative was able to work with companies of all sizes in productive and collaborative engagements on the diverse search process," says Maureen O'Brien, vice president and corporate governance director, Segal Marco Advisors, a member of the Midwest coalition.[3]

(continued)

What boards should know about engaging with investor coalitions *continued*

Climate risk

Main requests:

— Disclosure of plans to mitigate climate risk (e.g., two degree scenarios)

— Plans to minimize the climate impact of the companies' operations and/or products

— Improvement in the climate competency on boards (i.e., having directors who are experts in, or have a sufficient level of understanding of, climate risk)

— Commitment from the largest 20 utility companies to achieve net-zero carbon emissions by 2050

The business risks associated with climate change and the impact that companies' operations and products have on the environment are carefully assessed by institutional investors around the world. Several investor coalitions have been created to encourage companies to address these risks responsibly.

In 2017, the Global Investor Coalition on Climate Change worked with others to launch the Climate Action 100+ initiative, a coalition of more than 320 investors with over $33 trillion in assets under management which engages with more than 100 companies on "improving governance, curbing emissions and strengthening climate-related financial disclosure."[4] The companies targeted by this initiative have been identified by the group as being "important greenhouse gas emitters and other companies across the global economy that have significant opportunities to drive the clean energy transition and help achieve the goal of the Paris Agreement of limiting global warming to well below two-degrees Celsius."[5]

The Climate Majority Project works with institutional investors to encourage boards to increase the level of climate competency in the boardroom in order to "promote climate responsibility on corporate boards and accelerate economy-wide de-carbonization."[6] They recently partnered with New York City Comptroller Scott Stringer to form a "coalition of institutional investors representing some $1.8 trillion in combined assets to demand the 20 largest publicly traded electricity generators in the U.S. commit to achieving net-zero carbon emissions."[7] This coalition is calling on each of these utility companies to make a public commitment to this goal by 2050. In addition, they would like to see the companies assign board oversight of the transition to net-zero and for milestones to be incorporated into executive incentive programs prior to the 2020 proxy season.

Human capital management

Main requests:

— Disclosure of human capital management metrics

— Board-level oversight of human capital management issues

Given the importance of a company's employees in the performance and long-term success of a business, it is not surprising that investors are seeking more information about how companies are managing their human capital. The Human Capital Management Coalition was formed in 2013 to engage with companies to better understand their practices related to issues such as "the hiring and retention of employees, employee engagement, training, compensation and incentives, fair labor practices, health and safety, diversity, responsible contracting, ethics and corporate culture."[8] The group includes 27 institutional investors representing more than $3.5 trillion in assets under management.

In addition to coordinating engagement discussions between member investors and their portfolio companies, the coalition submitted a rulemaking petition to the Securities and Exchange Commission (SEC) in July 2017 calling for increased disclosure on human capital management practices, and recently submitted comments

"Directors should be aware of the issues that these investor coalitions are addressing in order to anticipate whether their companies may be targets of their requests, and, if so, to proactively plan for engagement with these groups."

to the SEC Investor Advisory Committee. "[T]he ability to effectively harness and apply the collective knowledge, skills, and experiences possessed by each individual in the workforce is essential to long-term value creation and is therefore material to investors evaluating a company's future performance," wrote Meredith Miller, Chief Corporate Governance Officer for the UAW Retiree Medical Benefits Trust, which leads the coalition. "Current disclosures leave investors with an incomplete picture of how well companies are seizing opportunities and managing risks."[9]

Opioid crisis

Main requests:

— Reports on board-level oversight of opioid-related business risks

— Governance reforms by boards of opioid companies

Pharmaceutical companies with exposure to opioid drugs, including drug manufacturers and distributors, are the focus of Investors for Opioid Accountability, a coalition of more than 55 investors representing over $4 trillion in assets under management. The coalition "came together out of escalating concerns that opioid company business risks can both threaten shareholder value and have profound long-term implications for the economy and society,"[10] according to Miller of UAW Retiree Medical Benefits Trust, one of the coalition's cofounders.

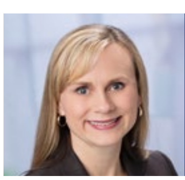
The coalition encourages companies to increase board-level oversight of, and accountability for, the risks associated with these drugs. Specifically, the group requests that the companies report on board-level oversight of the risks associated with opioids in addition to specific board leadership and executive compensation structures. For example, at the end of 2018 "a manufacturer of generic drugs and specialty pharmaceutical products, agreed to report on its oversight of opioid business risks, enhance its corporate lobbying disclosures and take other actions to increase the transparency of its efforts to handle opioids responsibly."[11]

Firearm safety

Main requests:

— Companies in the civilian firearms industry supply chain—demonstrate and disclose compliance with the Principles for a Responsible Civilian Firearms Industry

In response to the increase in mass shootings in the U.S., a group of 13 institutional investors, managing nearly $5 trillion, released the Principles for a Responsible Civilian Firearms Industry in November 2018. The Principles are designed to "provide a framework for institutional investors seeking to improve engagement with public and private companies globally that manufacture, distribute, sell or regulate products within the civilian firearms industry in order to address gun safety issues and reduce investment risk."[12] The members target companies all along the supply chain of the civilian firearms industry, including gun manufacturers and distributors, companies that sell civilian firearms, and those involved in the enforcement of industry regulations. They feel that these companies "are well positioned to support pragmatic transparency and safety measures that contribute to the responsible use of firearms."[13]



Annalisa Barrett is a Senior Advisor to the KPMG Board Leadership Center. She has more than 20 years of experience researching, writing, teaching, and presenting on corporate governance matters.

1 Thirty Percent Coalition website, About Us. https://www.30percentcoalition.org/who-we-are

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3 "Midwest Investor Diversity Initiative Reports 16 Companies Adopt Diverse Board Candidate Search Policies; Women, Minorities Appointed at 6 Companies," UAW Trust News Release. July 12, 2018.

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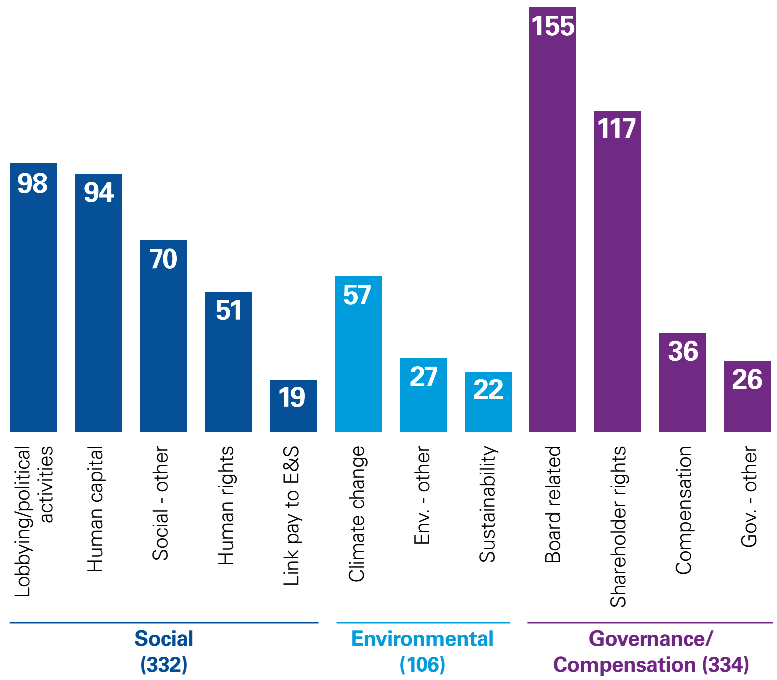
Environmental and social concerns rock the 2019 proxy vote

Environmental and social (E&S) proposals composed the majority of shareholder proposals filed for the third year in a row. "However, nearly half of the 438 E&S proposals filed were withdrawn, according to ISS Analytics, which signifies companies are "doing a good job of reaching out to shareholders" and negotiating, according to Pamela Marcogliese, reflecting on the 2019 proxy season during the recent KPMG Quarterly Webcast.

Total E&S proposals outnumber governance proposals in early 2019
number of shareholder proposal filings by proposal category (as of June 1, 2019)



Source: ISS Analytics as of June 1, 2019.

"Companies are increasingly better at presenting their views on some of the environmental, social, and governance (ESG) issues and have been spending a lot more time on these issues throughout the year. And shareholders are more proficient and have organized well," said Marcogliese, a partner at Cleary Gottlieb Steen & Hamilton in New York who advises companies on proxy disclosures, shareholder engagement, and other governance matters. "There has been better disclosure and better engagement on the company side and more organization on the shareholder proposal side," said Marcogliese. She added that "shareholder proposals for their own sake can often be counterproductive," and looks for both sides "to find ways to engage and connect and make progress" going into next year.

Joined by Stephen Brown, Senior Advisor, KPMG Board Leadership Center, Marcogliese reviewed recent proxy voting results and shared her views on shareholder proposals, board composition, and institutional investor trends.

Shareholder proposals

While nearly half of the E&S proposals filed were withdrawn, those E&S proposals that did go to a vote saw increasing support. Nearly a quarter of E&S-related proposals called for disclosure of lobbying and related political activity—largely driven by the upcoming presidential election. Governance proposals were less likely to be withdrawn, but more likely to be excluded than E&S proposals.

Marcogliese also highlighted the rise in employee/shareholder activism, particularly at companies with significant stock ownership by employees. "It's creating an interesting dynamic," she said. "You may have thought that shareholder proposals are limited to proxy season, but that's not the case when your employees are the shareholder proponents. The employee/shareholders show up to work [after the annual meeting] and continue the conversation."

Institutional investors

For the largest institutional investors, namely BlackRock, State Street, and Vanguard, which can own anywhere from 20 percent to 30 percent of a public company, "supporting proposals is really just a matter of last resort," said Marcogliese. "There's a difference between caring about [E&S] issues and thinking that a proposal is the right strategy for a company. Reaching out to shareholders, understanding what their individual issues are, and explaining to them what the company is doing is really the path forward." Investors are also taking individual and collective initiative to target specific issues such as climate change, gender pay equity, the use of plastics, opioids, and, recently, immigration detention.

Board composition

Board refreshment remains a top topic in boardrooms with investors "very focused on where women sit once they are on the board," says Marcogliese. "What committees are they on? Are they chairs?" According to the 2018 Spencer Stuart Board Index, 33 percent of new S&P 500 corporate directors were first-time directors and only 36 percent had C-suite experience. Women filled 45 percent of new Russell 3000 board seats in 2018 and ethnic minorities filled 15 percent.

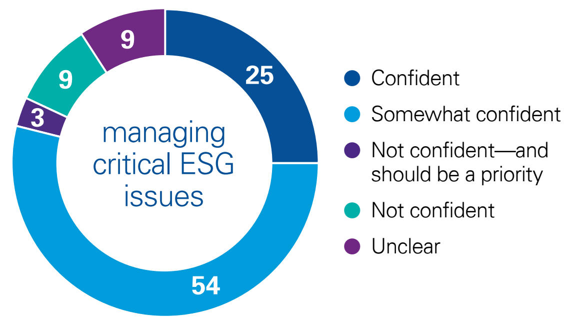
The conversation regarding board tenure "is a lot more thoughtful," said Marcogliese. Investors are focusing more on the mix of tenures on the board than on tenure alone, and they are placing greater focus on diversity in senior management. "What does the C-suite look like and what does the pipeline look like? What are your training programs and development and retention goals?" she asked. "There is significant focus from an engagement perspective in trying to understand what is going on."

Marcogliese also commented that directors should be mindful of over-boarding policies announced by institutional investors. "Unless companies and directors manage to these numbers, we're going to start seeing approval rates for director re-elections come down over the next couple of years."

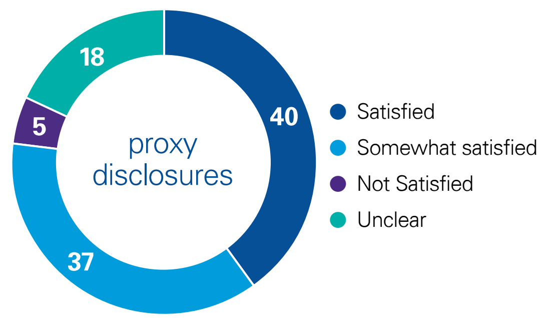
KPMG/NACD Quarterly Webcast survey results

Values shown in percentages

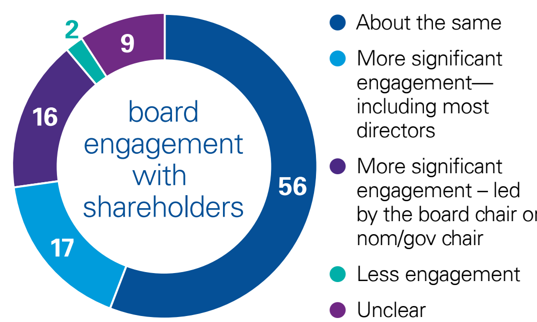
How confident are you that your company is aware of, and effectively managing, the critical ESG issues—e.g., environment and climate, health and safety, human rights, data privacy, diversity and corporate culture—that pose a material risk to the company's performance and reputation?



How satisfied are you that your company's proxy disclosures address key areas of interest to investors, such as strategy, culture, ESG, and board composition and diversity?



How has your board's engagement with shareholders changed over the past two to three years?



Of 305 self-identified corporate directors, senior executives, and senior legal advisors on the June 20, 2019, KPMG Quarterly Audit Committee Webcast.

"Off cycle" engagements

According to Marcogliese, it has become standard practice for companies to engage with their top investors outside of proxy season to discuss the company's long-term strategy and targets and to help build a firmer foundation for support. A clear agenda and preparation are key to successful shareholder engagements.

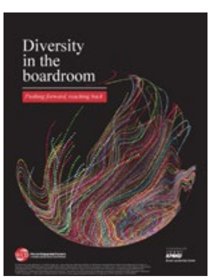
Find more highlights and information on upcoming webcasts at kpmg.com/aciwebcast.

Defining board diversity

The boardroom need for diversity—of thought, background, and experience—could not be more pressing in this era of change and disruption. In light of the data pointing to the value of diversity and the slow pace of change in the boardroom, pressure for board diversity is increasing globally, through gender quotas, media reports, and demands from institutional investors and other stakeholders, including employees and customers.

When a board is diverse and the dynamic is right, the benefit can be palpable. "Reading about the benefits of diversity in an article doesn't really mean as much as actually experiencing it. I'm seeing the benefits in real time as the board has become more diverse," said Joe Meyer, a member of the 2019 Women Corporate Directors' Thought Leadership Commission and founder of ExecThread, a start-up which initially had a board that was all male and predominantly white. Meyer acted with intentionality to change that paradigm, and now has a diverse board as well as a diverse senior management team. So what is different? "Board members are more thoughtful. We are getting a more interactive conversation and more balanced viewpoints," he said.

The 2019 Women Corporate Directors' Thought Leadership Commission report, *Diversity in the boardroom: Pushing forward, reaching back*, assesses the state of board diversity globally and provides practical recommendations based on the wisdom and experience of corporate board members and board governance thought leaders. The report considers what it takes to push forward to change the face of the boardroom and also how boards can reach back to drive change in their companies.



The 12 recommendations in the report have been categorized as "define, build, harvest, and sow." Defining board diversity thoughtfully and strategically is a critical first step. It requires the board and management to engage in a deep assessment of the needs of the company and the expectations of key stakeholders in both the country in which the company operates and the broader environment in which it does business, all through the lens of board composition and diversity.

Review and discuss the research on how diversity adds value in the boardroom

As investor, corporate director, and Commissioner John Rogers says about board diversity, "It's just common sense. The more people that are giving you fresh and new ideas, the better your organization will be." This common sense is borne out in much of the research on the functioning of diverse groups, and a high-level board discussion of how diversity adds value can be a helpful way to help bring everyone to the same page. As summarized by Catalyst in "Quick take: Why diversity and inclusion matter," a sampling of the studies published in the last few years show that:

- Diverse organizations are more successful at retaining talent
- Diverse teams are critical for innovation
- Mixed-gender boards have fewer instances of fraud
- Boardroom diversity strengthens corporate social responsibility performance
- Financial success parameters have been correlated with aspects of diversity over numerous and varied studies.

Toyah Miller and Maria del Carmen Triana, authors of the peer-reviewed academic study "Demographic diversity in the boardroom: Mediators of the board diversity-firm performance relationship," reviewed the academic literature finding mixed results on linkage between board diversity and overall performance and concluded: "The lack of a main effect between gender diversity and firm performance does not necessarily mean that gender diversity does not help firms. There may be something about the firm's environment that is not set up to allow the firm to achieve the benefits of a gender diverse board." Their study looked at impacts that are harder to quantify but are critical to long-term value—innovation and reputation. They found clear benefits of racial and gender board diversity with regard to innovation and a clear benefit between racial diversity and company reputation.

Use company strategy and stakeholder lenses to establish board diversity goals

In defining the parameters of diversity important to board composition, boards may want to consider the following questions:

- What is the demographic composition of the company's current: customers; suppliers; executive talent; and workforce?

- Over the next few years and the longer term: How do we expect each of these demographics to change? How do we want them to change? Are there untapped opportunities in currently underrepresented demographics?
- What do our stakeholders (defined as those listed above, investors, regulators, and others as relevant) expect from us with respect to board diversity?
- In light of all of these inputs, what are the implications for the composition of our board?

Many commissioners stressed the importance of alignment between board composition and company strategy. This applies to all measures of diversity. As Commissioner Esther Aguilera, chief executive of the Latino Corporate Directors Association, says, "It starts with taking a look at your company's employee demographics and customer base, not only the current demographics but also the trend." She continues, "Current and future customers and employees are the most valuable assets to any company, and their demographics should be reflected in the boardroom. Along the same lines, in the U.S., activist investors are targeting companies with a disconnect between a company's C-suite and board leadership and their customer base." As the board considers parameters of diversity that are aligned to strategic needs and stakeholder expectations, consider not only the company's internal data but also the broad demographic data and stakeholder trends such as the following:

- Seventy to eighty percent of all consumer purchase decisions are made by women
- The global purchasing power of the LGBT community is estimated at $3.7 trillion
- Hispanics constitute nearly 20 percent of the U.S. population and are continuing to grow
- Chinese consumers and companies are increasingly influential in the global marketplace.

German director and Commissioner Hiltrud Werner's companies use an international lens. She says, "We are looking at our global footprint, and asking 'what is our customer base that we have to understand…' China is a big market for us, for example. Understanding the demographics of our customer base is one key element that has helped us to widen our lens for diversity."

Construct a board matrix that considers multiple dimensions of diversity—skill set, background, and decision-making style

In public companies and many private companies, a board matrix is a routine part of the board-building process. The process, however, is not always robust. As one Commissioner says, "I've seen it done where there is a laundry list of skills and nothing changes from year to year." As the business environment and the company's needs change, some criteria will become less relevant and new ones will move to the forefront. Consider reviewing the board matrix each time the strategy is refreshed. In addition, consider defining (and disclosing) what qualifications are needed to satisfy each category, and rigorously placing check marks on the matrix only when truly appropriate (i.e., this is not an exercise in checking as many boxes as possible). Consider the criteria the board will include in the board composition matrix: Which skill sets are most relevant? How is diversity defined in light of the company's needs? What different types of decision-making styles will most add value in the boardroom?

For more insight from the report, go to *read.kpmg.us/wcd*.

Mark your calendar

NACD Master Class, Laguna Beach, CA
August 19–20

NACD's advanced Master Class foundation course for experienced lead directors, board chairs, and committee chairs will include peer-to-peer discussion, fireside chats, and interactive simulations.

Register at *www.NACDonline.org*.

Chair and Lead Director Symposium – NACD Global Board Leaders' Summit, Washington, DC
September 21

Sponsored by KPMG, this invitation-only half-day program brings together lead directors and chairs to discuss their most pressing leadership concerns and share leading practices and ideas that they can take back to their organizations.

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

Audit Committee Forum – NACD Global Board Leaders' Summit, Washington, DC
September 22

This daylong program sponsored by KPMG, will explore key issues for audit committees, including emerging concerns for internal audit, data and analytics' role in audit committee effectiveness, and updates on how policy and regulatory shifts are impacting financial reporting and disclosure.

Register at *www.NACDonline.org*.

KPMG Board Leadership Conference, San Diego, CA
January 6–8

This annual event for board directors, governance professionals, and business leaders explores the governance challenges and priorities driving board agendas through a combination of keynote speakers, panel discussions, breakout sessions, and committee-focused peer exchanges.

For more information, visit *kpmg.com/blc*.

Selected reading

Board development and director succession planning *WLRK via The CLS Blue Sky Blog*

Guide to internal control over financial reporting *Center for Audit Quality*

Assessing first-time candidates for non-executive directors *Spencer Stuart*

Task Force on Climate-related Financial Disclosures: Status report *TCFD*

Enlightened capital: The role of trust in impact investing *KPMG*

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

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