NACD® Directorship
Boardroom Intelligence

Reprinted from the January/February 2017 issue of *NACD Directorship* magazine

The Top 10 Issues for Boards in the New Year

By Dennis T. Whalen

JAMES ENDICOTT/ILLUSTRATIONSOURCE.COM

In 2017, strong corporate performance will still hinge on the essentials: managing key risks, innovating, capitalizing on new opportunities, and executing on strategy. But the context is changing quickly—and perhaps profoundly—as advances in technology, business model disruption, heightened expectations of investors and other stakeholders, and global volatility and political shifts challenge companies and their boards to rethink strategy development and execution, and what it means to be a corporate leader. Drawing on insights from KPMG's recent survey work and interactions with directors and business leaders over the past 12 months, here are 10 items that boards should keep in mind as they help guide their companies forward in the year ahead.

1. RECOGNIZE THAT CONNECTING AND CALIBRATING STRATEGY AND RISK ARE MORE CHALLENGING THAN EVER. What a difference a few months can make. The U.K.'s Brexit vote and a Trump victory in the United States—which caught most observers, and many corporate strategies, flat-footed—will have major implications for domestic policies, global markets, and the geopolitical landscape at large.

That so few pundits had predicted these sea changes despite exhaustive analysis in the run-up to both events is a stark reminder to businesses of how marketplace signals can be missed—be it status quo thinking, bias toward the familiar, or comfortable complacency—and the playing field fundamentally altered overnight.

The policy landscape will become clearer, but expect the competitive landscape to remain dynamic and opaque, leaving little lead time. Technological advances and relentless innovation, business model disruption, the ascendency of Millennials and other demographic shifts, evolving customer demands and employee expectations, and more will put a premium on corporate agility and the ability to pivot as conditions change.

Think constant transformation. Does management have an effective process to monitor changes in the external environment and test the continuing validity of strategic and risk assumptions? Does this process provide early warning that adjustments may be necessary? Does the board have the right people and perspectives to make the necessary linkages between external forces and the company's strategy and risk profile? Make strategy an ongoing discussion (versus an annual "decision") that incorporates smart risk taking and robust scenario planning with plenty of what-ifs on the table. In short, strategy and risk should be hardwired together and built into every boardroom discussion.

2. DEVELOP AND EXECUTE THE STRATEGY BASED ON TOTAL IMPACT. As we noted at the outset, the context for corporate performance is changing rapidly as political, social, and regulatory forces reshape the competitive landscape. Consideration of the corporation's role in society is moving from the periphery to the center of corporate thinking, as expectations of investors, customers, employees, and other stakeholders challenge companies to understand the total impact of the company's strategy and activities. Strategy development and execution requires a holistic approach, encompassing the full range of risks and opportunities—financial, reputational,

© Copyright 2017, National Association of Corporate Directors. All rights reserved.

While a robust risk management process is essential to preventing and mitigating risk events, it is not enough.

regulatory, resource- and talent-related, and more—that impact the company and its many stakeholders over the long term.

3. TAKE A HARD LOOK AT BOARD COMPOSITION. Is the talent in the boardroom aligned with the company's strategy and future needs? Given the demands of today's business and risk environment (and increasing scrutiny by investors, regulators, and the media), aligning boardroom talent with company strategy—both for the short term and the long term as the strategy evolves—should be a priority. Not surprisingly, 43 percent of respondents in our recent survey, *Building a Great Board*, cited "resistance to change" and "status quo thinking" as hampering their board-building efforts.

Also consider key recommendations of the *Report of the NACD Blue Ribbon Commission on Building the Strategic-Asset Board* and the Women Corporate Directors Foundation/KPMG report, *Seeing Far and Seeing Wide: Moving Toward a Visionary Board*. As noted in these reports, directors should focus squarely on board composition/diversity and succession planning, robust evaluations, tenure limits, director recruitment and onboarding, board leadership, stakeholder communications, and continuing director education—all tailored to the company and industry. In short, "periodic board refreshment" should give way to robust, continual improvement and active board succession planning.

4. PAY PARTICULAR ATTENTION TO POTENTIAL RISKS POSED BY TONE AT THE TOP, CULTURE, AND INCENTIVES. While a robust risk management process is essential to preventing and mitigating risk events, it is not enough. As we have seen in recent years, many of the crises that have posed the most damage to companies—financial, reputation, and legal—have been caused by a breakdown in the organization's tone at the top, culture, and incentives.

As a result, boards need to pay particular attention to these capital "R" risks, which may pose the greatest risk of all to the company. In today's business environment, it is more important than ever that the board be acutely sensitive to the tone from (and the example set by) leadership, and to reinforce the culture of the organization (i.e., what the company does and how it does it) and the culture of compliance, including a commitment to management of the company's key risks.

5. REASSESS THE COMPANY'S CRISIS PREVENTION AND READINESS EFFORTS. Crisis prevention and readiness has taken on increased importance and urgency for boards and management teams, as the list of crises that companies have found themselves facing in recent years grows longer. Crisis prevention goes hand in hand with good risk management—identifying and anticipating risks, and putting in place a system of controls to prevent such risk events and mitigate their impact should they occur.

We are clearly seeing an increased focus by boards on key operational risks across the extended global organization—e.g., supply chain and outsourcing risks, and information technology (IT) and data security risks. Do we understand the company's critical operational risks? What has 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?

Of course, even the best-prepared companies will experience a crisis. But companies that respond quickly and effectively tend to weather crises better. Assess how well the company's crisis planning aligns with its risk profile, how frequently the plan is refreshed, and the extent to which management and the board conduct mock crisis exercises. Do we have communications protocols in place to keep the board apprised of events and the company's response?

© Copyright 2017, National Association of Corporate Directors. All rights reserved.

Of course, even the best-prepared companies will experience a crisis. But companies that respond quickly and effectively tend to weather crises better.

6. REASSESS THE COMPANY'S SHAREHOLDER ENGAGEMENT PROGRAM. Shareholder engagement has been a top priority for companies for several years now, as institutional investors increasingly hold boards accountable for company performance and demand greater transparency, including direct engagement with independent directors. Institutional investors expect to engage with portfolio companies—especially when investors have governance concerns or where engagement is needed to make a more fully informed voting decision.

In some cases, investors are calling for engagement with independent directors. As a result, boards should periodically obtain updates from management about its engagement practices: Do we know and engage with our largest shareholders and understand their priorities? Do we have the right people on the engagement team? What is the board's position on meeting with investors? Which of the independent directors should be involved? Strategy, executive compensation, management performance, environmental and sustainability initiatives, and board composition and performance are likely on investors' radar.

As BlackRock's Laurence Fink emphasized in his February 2016 letter to the CEOs of S&P 500 companies, companies need to do more to articulate management's vision and plans for the future. He wrote: "This perspective on the future…is what investors and all stakeholders truly need, including, for example, how the company is navigating the competitive landscape, how it is innovating, how it is adapting to technological disruption or geopolitical events, where it is investing, and how it develops its talent.…Companies should work to develop financial metrics…that support a framework for long-term growth. Components of long-term compensation should be linked to these metrics."

7. REFINE AND WIDEN BOARDROOM DISCUSSIONS ABOUT CYBER RISK AND SECURITY. Despite the intensifying focus on cybersecurity, the cyber risk landscape remains fluid and opaque, even as expectations rise for more engaged oversight. As the cyber landscape evolves, board oversight—and the nature of the conversation—must also evolve. Discussions are shifting from prevention to an emphasis on detection and containment, and increasingly focused on the company's "adjacencies," which can serve as entry points for hackers. The Internet of things and the digital records that surround people, organizations, processes, and products ("code halos") require deeper—if not wholly different—conversations.

The board should help elevate the company's cyber risk mind-set to an enterprise level, including key business leaders, and help ensure that cyber risk is managed as a business or enterprise risk, not simply an IT risk. Do discussions about mergers and acquisitions, product development, expansion into new geographies, and relationships with suppliers, customers, partners, advisors, and other third parties factor in cyber risk? Help ensure that awareness of—and accountability for—cybersecurity permeates the organization, with a security mind-set, proper training, and preparation for incident response. Is cyber risk given regular and adequate time on the board's agenda? Does the board need a separate committee to focus on it? Where are the company's biggest vulnerabilities, and how is it protecting its most critical data sets? Do we benchmark against others in the industry? Do we have a cybersecurity scorecard and a robust cyber incident response plan? Do directors work under the assumption that any e-mail could become public at any time?

8. PREPARE FOR THE NEW CEO PAY RATIO DISCLOSURE. With the ongoing debate about income inequality and "excessive" CEO compensation, the Securities and Exchange Commission's (SEC's) CEO pay ratio disclosures will generate media attention for many companies. The new rules require companies to disclose the annual

© Copyright 2017, National Association of Corporate Directors. All rights reserved.

total compensation of the CEO, the median of the annual total compensation of all employees other than the CEO, and the ratio of these two numbers. (In October, the SEC issued additional guidance in the form of five Compliance and Disclosure Interpretations.)

While the disclosure is not required for most companies until their 2018 proxy statements (based on compensation for the 2017 fiscal year), companies should prepare now, given the significant steps that will be required to comply with the new rules, as well as the need to develop internal and external communications plans to explain the disparity between CEO and employee pay and why the CEO's compensation is appropriate. The explanation will be important both to investors and to employees, who will see how their compensation compares to others both within the company and with competitors.

9. GIVE NON-GAAP FINANCIAL MEASURES A PROMINENT PLACE ON THE AUDIT COMMITTEE AGENDA. In May 2016, after expressing concern about how companies are presenting non-GAAP financial measures, SEC staff published additional guidance on non-GAAP information to help companies evaluate the acceptability of non-GAAP financial information and their compliance with applicable rules and regulations. The following month, SEC Chair Mary Jo White reiterated this concern: "In too many cases, the non-GAAP information, which is meant to supplement the GAAP information, has become the key message to investors, crowding out and effectively supplanting the GAAP presentation."

Recent SEC comment letters have focused on the use of non-GAAP financial measures, and the SEC's Division of Enforcement has sent inquiries to companies regarding potential securities law violations. In this environment, it is critical that non-GAAP financial measures have a prominent place on the audit committee agenda. Have a robust dialogue with management about the process and controls by which management develops and selects the non-GAAP financial measures it provides, their correlation to the performance of the business and results, and whether the non-GAAP financial measures are being used to improve transparency and not to distort results.

10. REDOUBLE THE COMPANY'S FOCUS ON ETHICS, COMPLIANCE, AND CULTURE. Whether moving quickly to innovate and capitalize on opportunities in new markets, leveraging new technologies and data, and/or engaging with more vendors and third parties across longer and increasingly complex supply chains, most companies face heightened compliance risks. Coupled with the complex global regulatory environment (i.e., the array of healthcare, environmental, financial services, and data privacy regulations, as well as the Foreign Corrupt Practices Act and the U.K.'s Bribery Act of 2010), these compliance risks and vulnerabilities will require vigilance. 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.

Take a fresh look at the effectiveness of the company's whistleblower program. Does the audit committee see all whistleblower complaints? If not, what is the process to filter complaints that are ultimately reported to the audit committee? As a result of the radical transparency enabled by social media, the company's culture and values, its commitment to integrity and legal compliance, and its brand reputation are on display as never before. Ask for internal audit's thoughts on ways to assess the culture of the organization.

Read *On the 2017 Audit Committee Agenda* for more insights on these and other issues shaping audit committee and board practices at kpmg.com/blc.

Dennis T. Whalen, leader of the KPMG Board Leadership Center, frequently speaks on board governance and audit committee issues.

© Copyright 2017, National Association of Corporate Directors. All rights reserved.