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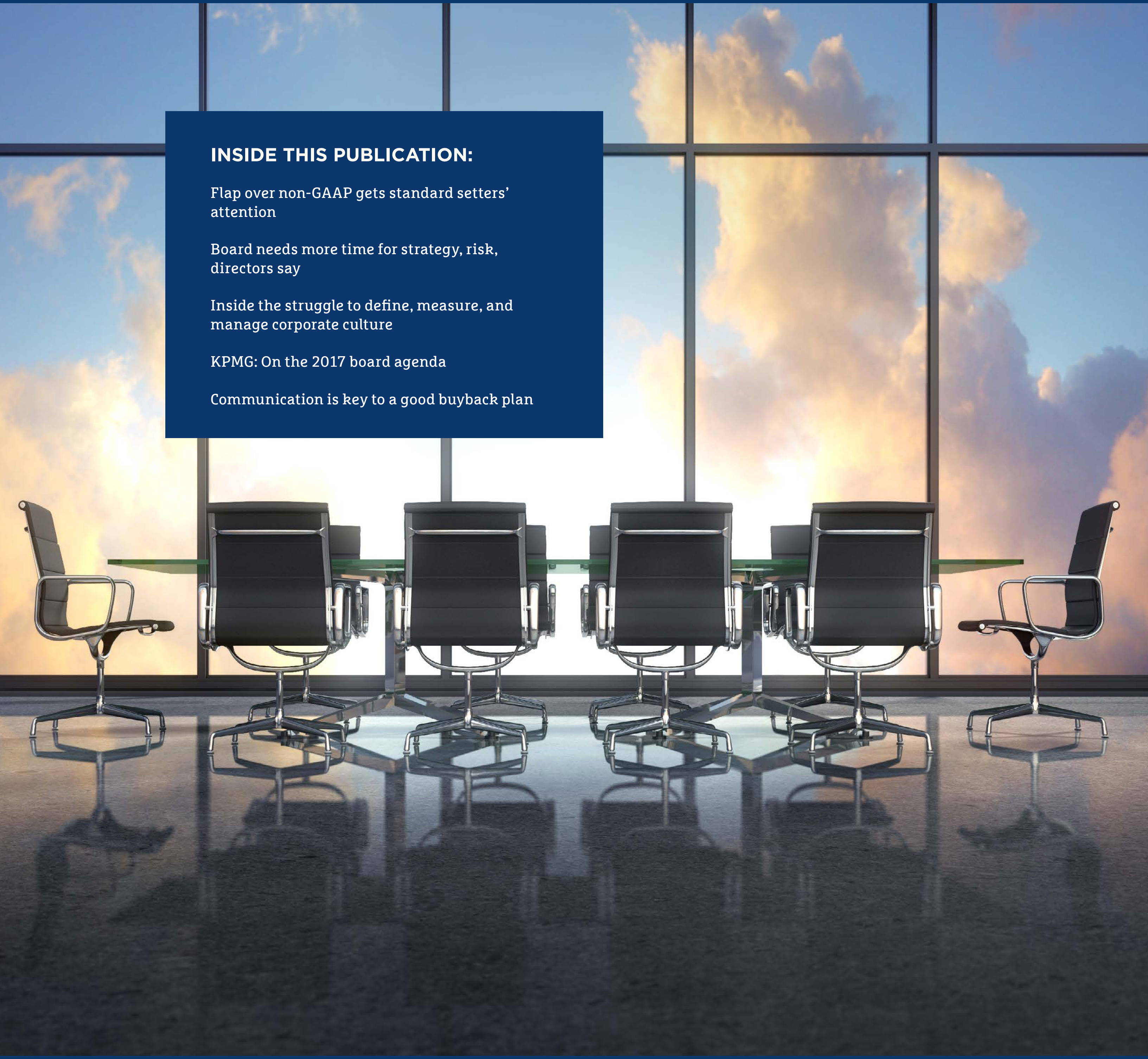

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An e-Book publication sponsored by KPMG

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COMPLIANCE WEEK

Compliance Week, published by Wilmington plc, is an information service on corporate governance, risk, and compliance that features a weekly electronic newsletter, a monthly print magazine, proprietary databases, industry-leading events, and a variety of interactive features and forums.

Founded in 2002, Compliance Week has become the go-to resource for public company risk, compliance, and audit executives; Compliance Week now reaches more than 60,000 financial, legal, audit, risk, and compliance executives.

KPMG

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 and Private Markets Group, the WomenCorporateDirectors Foundation, and more—the Center engages with directors and business leaders to help articulate their challenges and promote continuous improvement. Drawing on insights from KPMG professionals and governance experts worldwide, the Center delivers practical thought leadership—on risk and strategy, talent and technology, globalization and compliance, financial reporting and audit quality, and more—all through a board lens. Learn more at kpmg.com/blc.

Inside this e-Book

Flap over non-GAAP gets standard setters' attention

The disturbing rise of non-GAAP reporting in 2016 has prompted standard setters to take a closer look at whether changes to current rules are in order. **Tammy Whitehouse** explores.

The increased use and regulatory scrutiny around non-GAAP financial reporting measures in 2016 has prompted standard setters to take a closer look at whether changes to current standards are in order.

The Financial Accounting Standards Board is talking with its advisers and giving some thought to whether the flap over corporate uses of non-GAAP measures indicates changes to GAAP might be in order. FASB Chairman Russell Golden says in a recent statement that the board's Financial Accounting Standards Advisory Council has encouraged the board to continue to monitor non-GAAP reporting and consider where it might signal the need for improvements to GAAP.

The Securities and Exchange Commission placed a huge focus on non-GAAP reporting in 2016, urging companies to rein in excessive or even abusive uses of non-GAAP measures, concerned such reporting might be misleading to investors. SEC staff members said in the latter months of 2016 that they'd seen an improvement in reporting following the increased regulatory scrutiny.

Golden says some non-GAAP reporting reflects requests from investors, which then shapes the reporting companies provide to investors. "Changing GAAP in these situations can help develop a standardized approach that is more consistent with common reporting practices that investors find useful," he says. "In other words, it would improve the credibility of financial reporting."

FASB is in the midst of a research project on financial performance reporting broadly, looking to evaluate different alternatives for requiring more subtotals or more disaggregation of income or other performance measures, Golden says. "As we consider performance reporting improvements, it is important that we study non-GAAP measures that are commonly used in practice," he says.

Even the Public Company Accounting Oversight Board is taking note of the regulatory focus on non-GAAP reporting and considering whether changes to auditing standards might be warranted. The board recently updated its standard-setting agenda to include a research project focused on the auditor's role regarding other information outside the financial statements, including company performance metrics such as non-GAAP measures.

Recent publications from the CFA Institute would seem to suggest analysts and investors would welcome more consideration from standard setters about how non-GAAP reporting could inform the need for improvements to existing standards. A recent paper from the CFA Institute says regulatory focus to keep companies within the current guidelines that permit non-GAAP measures is not enough.

Concerns about non-GAAP reporting "should serve as a catalyst for the International Accounting Standards Board and the U.S. Financial Accounting Standards Board to enhance their primary financial statements' presentation and classification requirements, including defining key subtotals," the CFA Institute says. The group says its survey results show most investors expect and support the idea of new standard setting to provide more guidance around non-GAAP reporting, including "strong support for some level of assurance" around non-GAAP measures. ■

Board needs more time for strategy, risk, directors say

A KPMG roundtable series revealed that corporate boards don't spend enough time on strategy. **Tammy Whitehouse** has more.

Corporate boards just don't spend enough time on strategy, strategic risk, technology, cyber-security, executive succession planning, or talent development in general. Or at least so say some 700 corporate directors and senior executives in 16 U.S. cities who participated in a KPMG roundtable series on how the board prioritizes its agenda.

It's not small numbers of directors and executives who think the board doesn't spend enough time discerning corporate strategy or strategic risks. It was three-fourths of all survey participants who said they'd like to see the board devote more of its agenda to strategy and the risks that might arise from it. The numbers were smaller, however, on the other areas.

A little more than one-third, for example, believe the board should devote more time to technology and cyber-security issues as well as succession planning for the CEO and other top executives. One-fourth said the board could spend more time on the talent pipeline in general, according to the survey.

So where does the board find all this additional time? Nearly 40 percent said they'd like to see the board spend less time on financial reporting and disclosures, while 34 percent said they'd like to carve away from the time the board spends on audit and compliance. Sustainability and corporate social responsibility could also sacrifice some board time, according to 37 percent of respondents.

Still, one-fourth of respondents said they believe the board agenda is appropriately prioritized, so no changes are warranted. Roughly one-third said they believe the current annual average of 248 hours spent by board members on their board duties is just about right. Nearly 30 percent said they believe 248 hours is right, but they expect the commitment to increase going forward.

As business and risk become more complex, a board's ability to prioritize its time and devote enough of it to substantive issues becomes more critical, says Dennis Whalen, leader of KPMG's Board Leadership Center, which conducted the poll during its roundtable series. "Improving board effectiveness so that directors can devote more time to forward-looking or value-creating issues, while also remaining focused on compliance, operations, and so-called rear-view mirror items, may require a change in the nature of board and director engagement with management teams and among directors," he said. ■

Inside the struggle to define, measure, and manage corporate culture

Experts at the Compliance Week 2016 conference provided their insights on how to better define culture so it can be adequately managed and measured. **Tammy Whitehouse** has more.

Culture remains one of the most nebulous concepts in compliance, but in fits and starts companies are starting to get their arms around how to recognize it, manage it, and improve it.

At least a dozen different regulatory directives or frameworks make prominent references to corporate culture as the cornerstone of an effective compliance approach, but not a single one defines it, said Rich Girgenti, principal at KPMG and U.S. leader in forensic services for the firm. That includes pronouncements like the Sarbanes-Oxley Act, the Dodd-Frank Act, the Federal Sentencing Guidelines, the U.S. Justice Department's guide to FCPA, NYSE and NASDAQ listing standards, the COSO internal control framework, and even the more recent Yates memo.

No only do regulators not clearly define culture, they seem to go out of their way to avoid doing so, said Deborah Bailey, advisory managing director at KPMG. Yet most compliance professionals today know it when they see it, she said. Practice has come up with many different definitions that are not written with nearly as much authority as those bellwether regulatory directives. "But you know it and feel it, by and large, when you go in the door," she said.

Bailey and Girgenti teamed up with leaders in financial services and healthcare at the Compliance Week 2016 annual conference in Washington, DC, to provide some ideas on how compliance officers can better define corporate culture, which is the first step to better measuring and managing it.

It's a timely discussion, given calls from leaders in the internal audit profession to start performing some audit procedures around culture. The Institute of Internal Auditors published a white paper earlier this year encouraging members to start putting pencil to paper on how they could come up with an audit plan that would call attention to risks related to culture.

The paper provides a number of suggestions for cultural indicators that auditors could examine, like employee satisfaction and perceptions, training, customer complaints, whistleblower responses and protections, various HR practices, strength of leadership, and many others. The list extends far beyond examining whether the company has a written code of conduct or a policy on ethics.

Especially in the financial services sector, said Bailey, regulators have left a void for companies to fill. "They've challenged individual firms to figure this out and address this on their own," she said. "And the industry is really rallying around this and trying to address it in a significant way."

Mike Lamberth, managing vice president and senior compliance officer at Capital One Financial Corp., said the company tried to be clear and simple in its mission by using only four words: "change making for good." The double meanings are intentional. "We start by thinking about what it is we want people to do, then step back and see what could go wrong."

A simple mission focused on aligning to create pos-

“We start by thinking about what it is we want people to do, then step back and see what could go wrong.”

Mike Lamberth, Senior Compliance Officer, Capital One Financial Corp.

itive customer outcomes makes it easier for associates to understand what to do in any job function anywhere throughout the company, Lambert said, even in other countries. Employees will better internalize the idea of making lives better for customers than performing in a way that meets a legal threshold.

That led to a robust training program meant to instill a positive culture around the company’s mission. “Training has become an incredibly useful tool,” he said, although he anticipated the quiet groan that training advice might inspire. “I wasn’t against training. I was against bad training.”

It’s important, said Lambert, to develop an organization that is comfortable escalating concerns, questions and risks. And the escalation of issues should be prominent, the responsibility of more senior people in the organization who have more experience, he said.

All of that requires a formal approach to establishing culture, said Lambert. “You’ve got to get something formal in place, and do not make the mistake that says if you have it on paper, it’s the same as having culture.”

On-site polling at the conference suggested companies have some room to grow in terms of formalizing their approaches to establishing and assuring a positive culture. Almost half of participants said they don’t have a formal program for designing, implementing, and evaluating conduct and culture. Nearly 40 percent said they “never” use formal metrics for monitoring effectiveness of conduct and culture. Less than one-fourth said they report any kind of conduct or culture metrics to the board of directors.

John Crisan, chief compliance officer for Johnson & Johnson, said he’s in an industry sector a step down from financial services in terms of regulatory demands around culture. That doesn’t mean the company is any less committed, however. The company’s credo has been in place since the early 1940s. “It permeates our organization, and we measure against it,” he said. It even factors into performance evaluations.

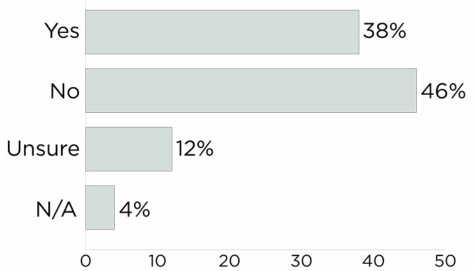
The primary means of measuring against the credo is an annual ethics survey, said Crisan. The survey changes each year to reflect emerging themes or trends or to ask questions around any concerns. The compliance program calls for plenty of personal visits to various locations, in part to assess culture. “You can tell a lot and you can sense where there’s a culture of compliance and ethics or something you want to pay a little more attention to,” he said.

Especially with third parties or recent acquisitions, site visits are critical, said Crisan. “You have to be in there, face to face,” he said. If a visit suggests concerns about whether business leadership there understands the expectations, it may be time to engage the legal department or other resources to escalate the concern.

Crisan also likes to leverage current events to use as teaching moments. “Never let a good crisis go to waste,” he said. When the Chinese government took action against a pharma, “you can bet I used that opportunity to talk to my Chinese partners and really drive home why compliance matters to us.”

Companies like Capital One and Johnson & Johnson have seen some success, said Girgenti, because they sought more than simply a compliance mindset. “They began by defining a higher purpose,” he said. “That it’s not just a compliance culture but it’s critical to business success. That played into building a culture of compliance and integrity.” ■

Do you have a formal program for designing, implementing & evaluating conduct & culture?



Source: CW 2016 poll

KPMG

On the 2017 board agenda

Board Leadership Center

In 2017, corporate performance will still require the essentials—managing key risks, innovating and 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 our recent survey work and interactions with directors and business leaders over the past 12 months, we've highlighted eight items that boards should keep in mind as they help guide the company forward in the year ahead.

Recognize that connecting and calibrating strategy and risk is more important—and more challenging—than ever. What a difference a few months can make. The UK's Brexit vote and a Trump win in the U.S., 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 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 fundamentally 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. Technology advances and relentless innovation, business model disruption, the emergence 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.

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

Take a hard look at the board's 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. Consider key recommendations of the *NACD Blue Ribbon Commission Report on Building the Strategic Asset Board* and the WCD Commission/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.

Pay particular attention to potential risks posed by tone at the top, culture, and incentives. While a robust risk management process is essential to prevent and mitigate 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 example set by) leadership and to reinforce the culture of the organization, i.e., what the company does, how it does it, and the culture of compliance, including a commitment to management of the company's key risks.

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 looms large. 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, information technology and data security risks, etc. 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—including robust communications—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?

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: "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."

Refine and widen boardroom discussions about cyber risk and security. Despite the intensifying

focus on cyber security, 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 continue to 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") call for deeper—if not wholly different—conversations. The board should help elevate the company's cyber-risk mind-set to an enterprise level, encompassing 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 M&A, product development, expansion into new geographies, and relationships with suppliers, customers, partners, advisers, and other third parties factor in cyber risk? Help ensure that awareness of—and accountability for—cyber security permeates the organization, with a security mind-set, proper training, and preparation for incident response. Is cyber security 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 email could become public at any time?

Prepare for the new CEO pay ratio disclosure.

With the ongoing debate about income inequality and "excessive" CEO compensation, the SEC's CEO pay ratio disclosures will generate media attention for many companies. The new SEC rules require companies to disclose the annual 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 staff issued additional guidance in the form of five Compliance and Disclosure Interpretations.) While the new 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).

Also see KPMG's *On the 2017 Audit Committee Agenda* at kpmg.com/blc.

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Communication is key to a good buyback plan

Stephen Davis & **Jon Lukomnik** look into why buybacks are so heavily criticized and what directors need to do to make a better case for them.

Buybacks get lots of bad press. Driven by low interest rates and a perceived lack of investment opportunities, American public companies spent $1.5 trillion buying back their own stock between 2013 and 2015. Critics claim that buybacks are the worst type of financial engineering, designed to prop up a company's stock in the short term. They say the money could be better used to invest in future growth to fund research and development, capital expenditures, and marketing. Proponents claim that buybacks are efficient ways to return capital to shareholders, who can make their own capital allocation decisions, rather than allow capital to build at corporations faced with limited investment options.

A report from the Investor Responsibility Research Center Institute and Tapestry Networks interviewed scores of directors to understand what was on their minds as they made the decision to institute, continue, stop, or change their companies' buyback programs. According to the report, directors said they supported buybacks for four overlapping reasons:

» To return "excess capital" to shareholders
» To invest in their own company shares
» To offset executive compensation that would otherwise be dilutive
» To change the capital structure of the company to better fit its business strategy

Here's how the Tapestry research changes the conversation. Public discussion of buybacks, together with academic scholarship, tends to lump all buyback programs together and to focus on capital market impact. But boards make repurchase decisions based on circumstances specific to a firm, and those reasons each have different analyses that drive the decisions and indicia of success. Let's look at each of them.

To have a successful buyback program driven by a desire to return "excess capital" to shareholders, directors first have to understand the level of capital needed to execute on a firm's business plan. Directors often look at working capital needs, investment opportunities, and dividend requirements. Success is defined as the material return of capital without affecting a company's ability to execute on its strategic plan.

By contrast, buyback programs, which are primarily designed to invest in a company's own shares, are driven by the gap between current market stock price and the perceived intrinsic value of the shares. Success is defined as achieving a targeted return on invested capital (the cost of the buyback). The director community is split on this rationale for buybacks. Some agree with investing guru Warren Buffet that he would not approve a buyback program absent the belief that shares are undervalued. But others note that directors and companies are notoriously poor stock pickers and that evidence suggests that buyback programs do not necessarily buy back undervalued shares or refrain from buying when shares are overvalued. Rather, buyback programs tend to occur when markets are rising.

If directors surveyed were split on buybacks based on intrinsic value, they were unified in believing that they should buy back shares to offset the dilution that would otherwise occur due to equity-linked executive compensation, and success is defined simply as offsetting dilution. The idea that offsetting dilution is a positive was almost universally believed and almost universally unexamined. Only one director suggested that if a company was using hard dollars to buy back shares to offset executive compensation dilution, then that was also an added compensation expense. A Gretchen Morgenson column in the *New York Times* publicized research from Wintergreen Advisors that also made that case. The Wintergreen study suggested that the average dilution from equity compensation for the S&P 500 was 2.5 percent of outstanding shares and that the incremental cost of offsetting the dilution was another 1.6 percent. If you take that data as accurate, it adds fuel to critics' charges that compensation cost at U.S. firms is excessive.

Finally, in rare cases, companies actually borrow to buy back shares. This is the result of a desire to redefine the balance sheet to better reflect the nature of a company's current business opportunities. For example, if a company is transitioning from a fast-growing company with many investment opportunities to a slower-growth, mature company with more stable revenues and less need to make investments in the future, it may opt for a more leveraged balance sheet. Success is defined as achieving a new capital structure better aligned to the company's current business.

Not surprisingly, directors interviewed by Tapestry overwhelmingly said they were actively and appropriately involved in making buyback and capital structure decisions. While a few directors suggested that the availability of buybacks and the perceived low-risk nature of them made companies irrationally risk adverse when thinking about other investments that could drive future value, most said that in the current low interest rate, low growth environment, companies could sustain both a buyback program and make all needed investments for the future.

Interestingly, the one area where directors largely agreed there was room for material improvement was in disclosure. For example, directors often said that buybacks were explicitly accounted for in making executive pay decisions, particularly when metrics such as earnings per share (which could be affected by buybacks) were involved. But fewer than four percent of the S&P 500 disclose that fact. Perhaps that's a contributing reason why the AFL-CIO this year introduced four shareholder resolutions asking companies to exclude the effects of buybacks on executive pay.

More basically, few disclose which of the four fundamental reasons drive the decision to embark upon a buyback program in the first place. Even fewer spell out for shareholders how they test the decision against downside risks or alternative approaches to the use of capital, or how they would monitor and define success, or what steps they would take to correct course if targets were not met. Absent that disclosure, it is difficult for investors to evaluate board diligence or to judge success or failure. As one director said, "investors will stand down if they understand what you are doing; but if they don't, they can be a little noisy."

Assuming boards are as diligent in vetting buybacks as the Tapestry research suggests, the challenge in buybacks (as in many other board decisions) boils down to making the disclosures necessary to give investors comfort that decisions are in shareholders' best interest. This isn't just a public relations exercise. We know from social science scholarship that when bodies know they are being watched by others, they tend to do better work. The need to disclose rationales, and goals could wind up sharpening board discussions and actions.

The lessons for companies and boards are clear: Understand why you're undertaking a buyback program; to the extent you can, eliminate unwanted consequences, such as unintended impacts on your executive compensation program; understand how you'll define success; and disclose, disclose, disclose.

There are also lessons for investors. As the Commonsense Principles of Corporate Governance, drafted by JPMorgan Chair/CEO Jamie Dimon and others, make clear, asset managers have an obligation to be clear about what they expect in the way of disclosure. That goes as much for buybacks as for any other governance matter. Institutional investors should disclose what factors they consider in analyzing whether a buyback program is positive over the long term.

If we can move toward this level of clarity by all capital market parties, it is possible to see judicious buybacks reclaiming market confidence. ■


Disruptive forces come in all shapes and sizes.
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