KPMG

# Directors Quarterly

## Insights from the Board Leadership Center

January 2021

## Looking forward: On the 2021 agenda

With light at the end of the tunnel—and an unprecedented year behind us—2021 stands to be a defining year for many companies and for corporate America. Corporate strategies, reputations, and resilience will be put to the test in an uneven economic recovery and with rising stakeholder expectations requiring a careful balance of near-term focus and long-term thinking. What lessons will the company—and the board—take from 2020 to position itself for the future?

In this edition of *Directors Quarterly*, we offer insights on the critical issues that should be high on board and committee agendas this year. We also look at tangible ways directors can help drive progress and accountability on diversity, equity, and inclusion in their boardrooms and companies. And J. Peter Scoblic, cofounder of Event Horizon Strategies, shares his thoughts on how to be more effective at seeing ahead—using scenario planning to help map uncertainty and "get a better grasp on the range of possible futures."

We also kick off the new year with our annual KPMG Board Leadership Conference, featuring, among others, political commentator David Axelrod; author Erik Larson; chef and philanthropist José Andrés; geopolitical luminaries Ian Bremmer, Katty Kay, and Richard Haass; and former PepsiCo Chairman and CEO Indra Nooyi—all sharing insights to help drive performance and purpose in the year ahead.

We hope you find *Directors Quarterly* helpful as you consider your board and committee agendas for 2021.

**John H. Rodi**
Leader
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### What's inside



### KPMG Board Insights

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# On the 2021 board agenda

COVID-19, recession, extreme weather events, deep-seated social unrest, and an increasingly polarized America all paint a picture of a daunting and opaque business and risk environment for the year ahead. Global volatility—driven by trade and geopolitical tensions, resurging debt, technology and business model disruption, elevated cyber risk, regulatory scrutiny, and political gridlock in the U.S. and elsewhere—will add to the challenge. The pressure on employees, management, boards, and governance will be significant.

Along with the business, boards will continue to operate against a backdrop of tremendous uncertainty, an uneven economic recovery, and heightened expectations of all stakeholders—investors, employees, customers, suppliers, and communities. Indeed, many boards will see 2020–2021 as an inflection point for corporate governance, with demands for greater attention to corporate purpose and stakeholder views, corporate culture and incentives, diversity and inclusion, the richness of boardroom dialogue and debate, and the company's (and board's) readiness for the risks and opportunities ahead—some of which may be backed up by investor votes against directors.

Drawing on insights from our latest survey work and interactions with directors and business leaders, we highlight nine issues for boards to keep in mind as they consider and carry out their 2021 agendas:

## Maintain focus on management's response to COVID-19, while keeping sight of the bigger picture.

COVID-19 will continue to redefine business as usual for nearly all companies—and their boards—regardless of industry, size, or geography. All leaders will face significant disruption and uncertainty—grappling with when and how to reopen, the implications of managing remote workforces, accelerating digital transformation, building more resilient supply chains, and strengthening connections with customers in the months to come. At the same time, some companies are finding new opportunities for growth in this uncertain environment.

Navigating the uncertainty will require a sharp focus on people, liquidity, operational risks, and contingencies while keeping sight of the bigger picture: strategy, risk, and resilience. With information about COVID-19 and the economy changing frequently, companies should expect to recalibrate their responses—and potentially reframe their thinking about how the COVID-19 crisis is impacting the business. As COVID-19 vaccines become widely available, consumer demand and jobs growth return, and the new reality takes shape, it will be critical to stay nimble and have a strategy for operating effectively, staying competitive, and eventually thriving.

Perhaps most important will be the continued attention to human resource issues, particularly reopening plans, employee safety, engagement, and morale, as well as normalizing work-from-home arrangements—while focusing on diversity and equity in the workplace. Companies may need to rethink how work is carried out and reassess the operational and policy implications of working remotely. Is management considering more flexible work-from-home policies longer term and the implications for workflow, efficiency, performance, talent development, and culture?

Leadership and communication regarding the company's reopening plans and strategy will be critical to retaining the trust and confidence of employees, customers, and investors. Understanding and compassion have become more important than ever: As many have emphasized, the company's stakeholders will remember how they were treated during COVID-19.

## Make human capital management and CEO succession a priority.

COVID-19 and social unrest since the summer have amplified the critical importance of human capital management (HCM) to a company's performance and reputation. Even before the pandemic, institutional investors were asking for better disclosure of how the board oversees human capital and talent development programs and their link to strategy. For example, the Human Capital Management Coalition, a group of institutional investors representing $6 trillion in assets, has been engaging with boards regarding their oversight of HCM and calling for better disclosure.

Some investors are expecting more robust disclosure on diversity. For example, in August 2020, State Street Global Advisors (SSGA) informed board chairs that starting in 2021, SSGA will ask companies in its investment portfolio "to articulate their risks, goals, and strategy as related to racial and ethnic diversity, and to make relevant disclosure available to shareholders." The letter emphasized, "[W]e are prepared to use our proxy voting authority to hold companies accountable for meeting our expectations."[1]

The U.S. Securities and Exchange Commission's (SEC's) new principles-based disclosure rule requires companies to provide a description of their human capital resources to the extent such disclosures would be material to an understanding of the company's business. To gain better oversight of HCM, many boards are charging the compensation committee (or another board committee) with oversight of talent development and related HCM issues and changing the name of the committee and its charter to reflect these additional responsibilities. Boards will want to discuss with management the company's human capital resources disclosures in the proxy statement and 2020 Form 10-K, including management's processes for developing any related metrics, and help ensure that the disclosures demonstrate the company's commitment to these critical human capital issues. Those discussions should help deepen the board's understanding of the company's HCM strategies and better integrate HCM into the board's agenda and priorities.

Does management's talent plan align with its strategy and forecast needs for the short and long term? Has management considered whether reskilling of certain categories of employees makes sense? Which talent categories are in short supply and how will the company successfully compete for this talent? More broadly, as millennials and younger employees join the workforce in large numbers and talent pools become globally diverse, is the company positioned to attract, develop, and retain top talent at all levels?

For its part in HCM, the board should help ensure that the company is well prepared for a CEO change. Are succession plans (including emergency succession plans) for the CEO and other C-suite roles formalized and reviewed at least annually (if not more often), and which board committee is responsible? In considering potential CEO successors, the board should ensure that if the business and strategy have changed as a result of the impact of COVID-19, the desired profile of a new CEO has been updated accordingly. The numerous crises of 2020 may require other changes in the succession pipeline, with some skills becoming more important, and some executives having stepped up with steady leadership in the face of tremendous uncertainty. How does the board get to know senior executives in the leadership pipeline—particularly given the limitations of a remote work environment?

## Ask whether the company is doing enough to make real and lasting changes to combat systemic bias and racism.

The disproportionate impact of COVID-19 on communities of color and the social unrest following the death of George Floyd and others are driving a critical dialogue about systemic racism and inequities across the nation, and across corporate America.[2] Are companies doing enough—using their financial resources, advocating for public policies, engaging in public/private partnerships, and leading by example ("walking the walk")—to make real and lasting changes to combat systemic bias and racism?

Listening and acknowledging the injustices that Black Americans and communities of color have long suffered is imperative, and speaking out with statements of concern and support is important. Yet, communities, employees, customers, and investors are calling on companies to drive lasting change—to back up their words with action, and to show measurable progress.[3]

On a BLC webcast, speakers highlighted a number of considerations for more robust conversations about diversity and inclusion, including clearly committing to building the company's pipeline of diverse employees at all levels and among its board members; defining diversity and considering setting aggressive goals at all levels; measuring progress and holding the CEO and leadership team accountable; considering vendors' diversity practices; and telling the company's diversity story. How the company addresses these issues may affect its reputation, ability to attract and retain talent, and the views of customers. See *Race and accountability in the boardroom*.

[1] Richard F Lacaille, "Diversity Strategy, Goals & Disclosure: Our Expectations for Public Companies," State Street Global Advisors, August 27, 2020.
[2] Maria Godoy, "What Do Coronavirus Racial Disparities Look Like State By State?" NPR, May 30, 2020.
[3] Richard Edelman, "Systemic Racism: The Existential Challenge for Business, Edelman.com, September 8, 2020.

## Reevaluate the company's focus on ESG and corporate purpose.

Corporate growth and shareholder return still require the essentials—managing key risks, innovating, capitalizing on new opportunities, and executing on strategy—but the context for corporate performance is changing quickly and COVID-19 is accelerating that change. The ongoing challenges of stagnant wages, income inequality, climate and environmental issues, health and safety, and diversity and inclusion—with limited government solutions—continue to spotlight corporate America's role: What is the company's responsibility to society and the stakeholders it relies on for growth?

Employee and consumer activism regarding environmental, social, and governance (ESG) issues continues to grow, with millennials leading the way. Shareholders continue to submit more proposals on ESG issues—particularly the "E" and the "S" issues related to COVID-19.

There are increasing stakeholder demands for clearer disclosure of how the company is addressing ESG risks and opportunities—particularly climate change and diversity. Which ESG issues are of strategic significance—i.e., key to the company's long-term performance and value creation? How is the company embedding ESG into its core business activities (strategy, operations, risk management, incentives, and corporate culture)? Is there a clear commitment and strong leadership from the top as well as enterprise-wide buy-in? For more on communicating ESG-related activities to shareholders, see *On the 2021 audit committee agenda* and *On the 2021 nom/gov committee agenda*.

## Reassess whether crisis readiness and resilience plans are effectively linked to the company's key risks.

COVID-19 is a stark reminder of the need to have robust enterprise risk management (ERM) processes that are closely linked to crisis preparedness and resilience. Are the company's risk governance processes keeping pace with its changing risk profile? Does the board understand who owns key risks at the management level, and would an empowered chief risk officer help create a more unified approach to risk? The events and crises of 2020 suggest a number of fundamental questions for boards and management teams as they reassess the company's risks and readiness, including:

*Do we have a complete inventory of the company's critical risks?* COVID-19 has surfaced a range of heightened risks to manage, from employee and customer health and safety and managing remote workforces to the acceleration of digital transformation, changing customer demands, and vulnerable supply chains. Extreme weather events—droughts, wildfires, hurricanes, flooding, rising sea levels—illustrate the risks that climate change poses to companies, supply chains, and customers. (A majority of directors and investors surveyed recognize climate severity as a risk that is impacting the company today.[4]) COVID-19 and social unrest have cast a bright light on a host of ESG risks that should be front and center for business leaders—including employee well-being, pay equity, racial and gender diversity, and human rights, and how companies are meeting their commitments to stakeholders. Management will need to regularly reassess the risk landscape in light of the dynamic operating environment.

*Are crisis readiness plans closely linked to risk management—and are we prepared for a worst-case scenario?* Even the best ERM isn't going to prevent every crisis. Companies need crisis response plans with a focus on agility, resilience, and values—maintaining operations and company reputation in the face of disaster and learning from past crises. Identifying likely crisis scenarios and practicing responses using tabletop exercises is critical. Prepare for the worst-case scenarios—e.g., extended periods of supply chain disruption, substantial sustained reduction in sales and revenue, and the loss of key personnel—and consider having the board participate in these exercises.

*Does the board's committee structure bring the right focus and attention to the company's critical risks and its crisis readiness and resilience?* Are the risk oversight responsibilities of each committee clear? Does that allocation of responsibilities still make sense—particularly in light of the changing risk environment? While boards may be reluctant to establish an additional committee, considering whether a finance, technology, risk, sustainability, or other committee would improve the board's effectiveness can be a healthy part of the risk oversight discussion. Also consider whether risks should be reallocated among committees, and whether committees have directors with the necessary skills to oversee the risks their committees have been assigned.

## Approach cybersecurity and data privacy holistically as data governance.

The accelerated shift to digital that many companies are experiencing underscores a trend we highlighted last year: the importance of taking a holistic approach to data governance—the processes and protocols in place around the integrity, protection, availability, and use of data.

Boards have made strides in monitoring management's cybersecurity effectiveness—for example, with greater IT expertise on the board and relevant committees, company-specific dashboard reporting of key risks, and more robust conversations with management focusing on operational resilience and the strategies and capabilities that management has deployed to minimize the duration and impact of a serious cyber breach. Despite these efforts, given the growing sophistication of cyber attackers, the shifts to remote work, and online customer engagement, cybersecurity will continue to be a key challenge.

The broader challenge is data governance, encompassing compliance with industry-specific privacy laws and regulations, as well as new privacy laws and regulations that

[4] Kristin Bresnahan et al., "Global Investor-Director Survey on Climate Risk Management," Ira M. Millstein Center for Global Markets and Corporate Ownership at Columbia Law School and LeaderXXchange, October 13, 2020.

govern how personal data—from customers, employees, or vendors—is processed, stored, collected, and used. It also includes the company's policies and protocols regarding data ethics—in particular, managing the tension between how the company may use customer data in a legally permissible way with customer expectations. Managing this tension poses significant reputation and trust risks for companies and represents a critical challenge for leadership. To help develop a more rigorous approach around oversight of data governance:

- Insist on a robust data governance framework that makes clear how and what data is being collected, stored, managed, and used—and who makes decisions regarding these issues.
- Clarify which business leaders are responsible for data governance across the enterprise—including the roles of the chief information officer, chief information security officer, and chief compliance officer.
- Reassess how the board—through its committee structure—assigns and coordinates oversight responsibility for both the company's cybersecurity and data governance frameworks, including privacy, ethics, and hygiene.

## Help set the tone and monitor the culture throughout the organization.

COVID-19 has increased the risk of ethics and compliance failures, particularly given heightened fraud risk due to employee financial hardship and the pressure on management to meet financial targets. Closely monitor the tone at the top and culture throughout the organization with a sharp focus on behaviors (not just results) and yellow flags. Is senior management sensitive to the human resource issues stemming from COVID-19, particularly the pressures on employees (in the office and at home), employee health and safety, productivity, engagement and morale, and normalizing work-from-home arrangements? Does the company make it safe for people to do the right thing? Headlines of lax data privacy protections, aggressive sales practices, and other lapses continue to put corporate culture front and center for companies, shareholders, regulators, employees, and customers. Boards themselves are also making headlines—particularly in cases of self-inflicted corporate crises—with investors, regulators, and others asking, "Where was the board?"

Given the critical role that corporate culture plays in driving a company's performance and reputation, we see boards taking a more proactive approach to understanding, shaping, and assessing corporate culture. Have a laser-like focus on the tone set by senior management and zero tolerance for conduct that is inconsistent with the company's values and ethical standards, including any "code of silence" around such conduct. Be sensitive to early warning signs. Verify that the company has robust whistle-blower and other reporting mechanisms in place and that employees are using them without fear of retaliation.

Understand the company's *actual* culture (how things get done versus the rules posted on the breakroom wall); use all the tools available—surveys, internal audit, hotlines, social media, walking the halls, and visiting facilities (safety protocols permitting)—to monitor the culture and see it in action. Recognize that the tone at the top is easier to gauge than the mood in the middle and the buzz at the bottom. How does the board gain visibility into the middle and bottom levels of the organization? Make sure that incentive structures align with strategy and encourage the right behaviors, and take a hard look at the board's own culture for signs of groupthink or discussions that lack independence or contrarian voices. Culture and strategy are inextricably linked. If the company's strategy has changed as a result of COVID-19 and related impacts, carefully consider what changes to the culture may be necessary to support the new strategy.

## Build the talent in the boardroom around the company's strategy and future needs.

Boards are increasingly focused on aligning board composition with the company's strategy, today and for the longer term. Talent and diversity in the boardroom are also top of mind for investors, regulators, and other stakeholders. That said, it's clear that the world is changing markedly faster than boards.

According to Spencer Stuart's 2020 U.S. Board Index of S&P 500 companies, board turnover remains low (0.84 new directors per board annually). Average director tenure (7.9 years) has changed little, and nearly 14 percent of boards have an average tenure for independent directors of 11–15 years of service while average director age has *risen* slightly in the last decade (to 63.0). Progress on board diversity continues, but there is still a long way to go—28 percent of S&P 500 directors are women, and 20 percent of the directors in the top 200 of these companies are African American, Latino, or Asian. Tenure-limiting mechanisms—term limits and mandatory age limits—have had limited impact, and that is not surprising: only 6 percent of boards have term limits for independent directors, and nearly half (48 percent) of boards with age limits have a mandatory retirement age of 75 or older, compared with just 19 percent a decade ago. Retirement ages continue to rise.[5]

The increased level of investor engagement on this topic highlights investor frustration over the slow pace of change in boardrooms and points to the central challenge with board composition: a changing business and risk landscape. Addressing competitive threats and business model disruption, technology and digital innovation, cyber risk, ESG issues, and global volatility requires a proactive approach to board-building and board diversity—of skills, experience, gender, and race/ethnicity. As part of its Boardroom Accountability Project 3.0, in October 2019, the New York City Comptroller sent letters to a number of S&P 500 companies requesting that they adopt a diversity search policy *requiring* that the initial lists of candidates from which new management-supported director nominees and chief executive officers (CEOs) are chosen include qualified female and racially/ethnically diverse candidates (sometimes referred to as the "Rooney Rule").[6]

[5] 2020 Spencer Stuart U.S. Board Index.
[6] Michael Garland, "Using 'Rooney Rule' To Advance CEO Diversity," Proxy Preview, March 17, 2020.

Proxy advisors ISS and Glass Lewis have updated their voting policies to take a stronger stance on board diversity, including the use of votes against directors to drive progress.[7] Board composition and diversity should remain a key area of board focus in 2021, as a topic for communications with the company's institutional investors, enhanced disclosure in the company's proxy, and to help position the board strategically for the future. Indeed, legislative action around the country pushing for diversity—including California's laws mandating diversity of gender, race, ethnicity, and sexual orientation in the boardroom and votes against directors by an increasing number of institutional investors for a lack of diversity—should serve to sharpen every board's focus on diversity as a business imperative.

## Be proactive in engaging with shareholders and activists.

Shareholder engagement continues to be a priority for companies as institutional investors increasingly hold boards accountable for company performance and demand greater transparency, including direct engagement with independent directors. Institutional investors expect to be able to engage with portfolio companies—especially when there are governance concerns or when engagement is needed to make a more fully informed voting decision. In light of COVID-19, transparency, authenticity, and trust (or lack thereof) are increasingly important themes for engagement with shareholders. "Thinking like an activist" will remain an important exercise, particularly if COVID-19 has exacerbated the company's vulnerabilities.

Boards and management must be thinking about engaging not only with shareholders but with their own employees, customers, suppliers, and community stakeholders. Boards should request periodic updates from management about the company's engagement practices: Do we know and engage with our largest shareholders and key stakeholders and understand their priorities? Do we have the right people on the engagement team? What is the board's position on meeting with investors and stakeholders? Which independent directors should be involved? And perhaps most importantly, is the company providing investors and stakeholders with a clear, current picture of its performance, challenges, and long-term vision?

Strategy, executive compensation, management performance, ESG initiatives, human capital management, and board composition and performance will remain squarely on investors' radars during the 2021 proxy season. We also expect investors and stakeholders to focus on how companies are adapting their strategies to address the continuing impact of COVID-19 and the economic and geopolitical uncertainties and dynamics shaping the business and risk environment in 2021. ■

[7] See "ISS Americas Proxy Voting Guidelines Updates for 2021," and "Glass Lewis 2021 Proxy Paper Guidelines Unites States."

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# On the 2021 audit committee agenda

Similar to the complex array of issues shaping the full board's agenda, prioritizing a heavy audit committee agenda will be particularly challenging. Audit committees will continue to operate against a backdrop of tremendous uncertainty and an uneven economic recovery. Drawing on insights from our latest survey work and interactions with audit committees and business leaders, we highlight seven issues for audit committees to keep in mind as they consider and carry out their 2021 agendas:

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

It is little surprise that more than 60 percent of audit committee members we surveyed report that COVID-19 has prompted the committee to reassess the scope of its agenda and risk oversight responsibilities.[1] Beyond financial reporting and related control risks, many audit committees indicate they have substantial oversight responsibility for a range of other risks, including financial risks such as liquidity and access to capital; legal/regulatory compliance; cybersecurity and data privacy; reporting of environmental, social, and governance (ESG) metrics; supply chain and other third-party risks; health and safety; and other operational risks posed by the COVID-19 environment.

Keeping the audit committee's agenda focused will require vigilance. Virtually all companies will continue to deal with significant disruption and uncertainty, and will grapple with reopening the business and managing a remote workforce, accelerating digital transformation, building more resilient supply chains, and strengthening connections with customers—all while attempting to innovate and take advantage of opportunities arising from this disruption. To address the ongoing disruption, audit committees are asking management to update and stress test risk assessments, scenario planning, and crisis protocols. Does the audit committee have the time and expertise to oversee the major risks now on its plate? Does cyber risk require more attention at the full-board level—or perhaps a different board committee? Is there a need for a compliance or risk committee? Where does oversight of ESG metrics and reporting belong? Many boards are reluctant to create an additional committee, but considering whether a finance, technology, risk, sustainability, or other committee would improve the board's effectiveness can be a healthy part of the risk oversight discussion. Also consider reallocating risk oversight duties among the board's existing committees.

## Monitor the financial reporting and disclosure impacts of COVID-19 on the company's filings.

The financial reporting, accounting, and disclosure impacts of COVID-19 are far-reaching and will continue to unfold in 2021. Among the key areas of audit committee focus for the company's 2020 Form 10-K and 2021 filings:

— **Forecasting and disclosures.** The uncertain trajectory of COVID-19 and the economy—coupled with the extensive use of forward-looking information in financial statements and SEC filings—have made disclosures regarding the current and potential effects of COVID-19 (e.g., risk factors, Management Discussion & Analysis (MD&A), liquidity, results of operations, and known trends and uncertainties) a top area of focus. As identified in our survey, other prominent areas of audit committee attention include preparation of forward-looking cash-flow estimates; impairment of nonfinancial assets, including goodwill and other intangible assets;

[1] KPMG Audit Committee Institute, Challenges presented by COVID-19, October 5, 2020.

accounting for financial assets, including fair value; going concern; and use of non-GAAP metrics. CF Disclosure Guidance Topic No. 9A, issued by the staff of the Securities and Exchange Commission's Division of Corporation Finance, provides companies affected by COVID-19 additional guidance on disclosure considerations for the financial statements and MD&A. The SEC wants companies to provide disclosure that allows investors to evaluate the impact of COVID-19 through the eyes of management and to revise and update that disclosure as circumstances change.

— **Accounting for government assistance.** Assistance under the Coronavirus Aid, Relief, and Economic Security (CARES) Act may take different forms, including favorable loans (some or all of which may be forgiven) and loan guarantees, grants, credits, payroll and payroll tax support, and reimbursement of healthcare-related expenses and/or lost revenue. Loans and grants obtained under these programs generally impose significant restrictions on the recipient and some require the issuance to the U.S. Treasury of stock warrants or other equity interests. Companies receiving government assistance need to determine the appropriate revenue recognition model.

— **Internal control over financial reporting (ICFR).** Companies are reassessing, enhancing, or establishing new internal controls due to COVID-19-related disruptions to business operations, including IT system access and authentication to enable a remote/virtual workforce, cybersecurity, entity-level controls (communication and assignment of authority, segregation of duties, access review controls), return-to-work plans, and data privacy. In the event of material changes in ICFR, disclosure is required.

## Reinforce audit quality and understand the impact of COVID-19 on the external audit process.

Audit committees should understand what changes to the audit process auditors are making in light of COVID-19 and why. As a starting point, the external auditor needs to conduct incremental risk assessment procedures that are sufficient to provide a reasonable basis for identifying and assessing the risks of material misstatement (whether due to error or fraud), and design further audit procedures. What changes in audit scope and revisions to the audit approach are necessary? The Center for Audit Quality's *Focus on the Auditor's Risk Assessment* identifies new or different risks the auditor may need to consider, including:

— Liquidity, access to capital, debt covenant compliance

— Ability to continue as a going concern

— Cybersecurity, including data security in a virtual environment

— Changes in ICFR due to working in a virtual environment including information technology general controls

— Asset and goodwill impairment

— Fair-value estimates

— Third-party vendor considerations

— Industry-specific regulatory and economic considerations, including concentration risk

— Geographic-specific regulatory and economic considerations, including concentration risk

— Business interruption

— Heightened risk of fraud due to COVID-19.

The internal control environment is a critical area of focus. With the shift to remote working and financial reporting processes moving from in-person to virtual, there is an increased risk of internal control breakdowns. In evaluating the design and implementation of controls relevant to the audit, an important area of auditor focus will be on how controls may have changed during COVID-19 to accommodate remote workforces and process flows. What new controls or changes to controls have been required as a result of risks posed by, among other things, the work-from-home environment, change in reporting lines or new people responsible for controls, and increased fraud risk due to employee financial hardship as well as management pressure to meet financial targets?

The PCAOB has highlighted the importance of frequent communication with the auditor as a result of COVID-19, and offered the following considerations:[2]

— Engage with the auditor and management to discuss potential challenges to a timely completion of the audit. Review and discuss the timeline for the phases of work.

[2] PCAOB—Conversations with Audit Committee Chairs: COVID-19 and the Audit, July 2020.

- Determine a good cadence for communications that include both the auditor and management so that the audit committee receives the information it needs in a timely manner, while also considering the additional demands on auditors and management during the pandemic.
- Discuss any changes to the audit plan with the auditor, including changes to areas of focus and how the auditor plans to address new or modified areas of risk. Discuss if there are changes to how the auditor will identify and test internal controls plans.
- Discuss which disclosures may need to change as a result of COVID-19.

Finally, as the PCAOB noted, audit committees should discuss with the auditor the challenges and risks of conducting the audit remotely. For example, what alternative methods are available for conducting physical inventory counts? Will additional time be needed to get the audit work done remotely? What complexity does working remotely add to the audit?

### Work with management to reassess and oversee the scope and quality of the company's ESG/sustainability reports and disclosures.

For several years, companies have faced increasing demands—from investors, research and ratings firms, activists, employees, customers, and others—for more transparent and higher-quality information about ESG issues and risks. How does the company define its corporate purpose, and how does it consider the interests of stakeholders—employees, customers, suppliers, and communities—in addition to shareholders? These demands increasingly have teeth, particularly from investors exerting pressure during shareholder engagement and director elections. For example, Institutional Shareholder Services (ISS) stated that, for annual meetings held on or after February 1, 2021, "demonstrably poor risk oversight of environmental and social issues, including climate change" may trigger a vote against or withhold from directors.[3] Boards also risk potential lawsuits and exposure if the company discusses these issues (such as a commitment to diversity) in a manner that does not align with what is happening on the ground. We expect the 2021 proxy season to feature a significant number of ESG proposals.

The events of the past year—COVID-19, its disproportionate impacts on employees and communities of color, and the social unrest triggered after the death of George Floyd and others—have focused companies on the "S" in ESG. For example, how a company addresses employee issues such as diversity and racial inequality, health and safety, sick leave, and work-from-home arrangements and communicates with suppliers and customers regarding their COVID-19-related challenges highlights the importance of the "S" issues. How the company considers its stakeholders in creating sustainable long-term value may have a major impact on reputation. And stakeholder demands are not limited to social issues. Disclosure on climate issues continues to be a high priority for many institutional investors. More than 90 percent of respondents to Morrow Sodali's Institutional Investor Survey 2020 expect companies to demonstrate a link between financial risks, opportunities, and outcomes with climate-related disclosure.[4]

Stakeholder demands for more detailed sustainability/ESG reporting include requests for comparable and consistent information that is actionable from an investment perspective (and an explanation of how it links to strategy and performance). Audit committees should encourage their management teams to reassess the scope and quality of the company's sustainability/ESG reports and disclosures—including benchmarking against peers, consideration of the methodologies and standards of ESG raters (which may vary widely), and ESG reporting frameworks.

Whether on a website, sustainability report, or in an SEC filing, the audit committee should ask, what controls are in place to ensure the quality of the ESG information being disclosed? Is it reviewed with the same rigor as financial information? Does (or should) the company obtain third-party assurance on the ESG information to provide investors with a greater level of comfort? Does the audit committee understand and receive reports on the basis for and processes used to generate the disclosures? Beyond ratings, this is about how ESG risks and opportunities are handled and their impact on the creation of long-term value, whether investors elect to invest (or not) based upon a company's ESG profile, and cost of capital. Stating its view that "a company's ESG score will soon effectively be as important as its credit rating," State Street Global Advisors said it would take voting action against directors at companies that were

[3] Institutional Shareholder Services, Inc., "Americas Proxy Voting Guidelines Updates for 2021," published November 12, 2020.

[4] Kiran Vasantham and David Shammai, Institutional Investor Survey 2020, Morrow Sodali, March 2020.

laggards based on their ESG scores (as determined by State Street) and that could not articulate how they planned to improve their scores.[5] Similarly, BlackRock has indicated that it will also vote against directors for a lack of progress on ESG.[6]

Investors want to understand which ESG issues are of strategic significance to the company. How is the company addressing ESG as a long-term strategic issue and embedding it into the company's core business activities (strategy, operations, risk management, incentives, and corporate culture) to drive long-term performance and value creation? Is there a clear commitment and strong leadership from the top as well as enterprise-wide buy-in? As one director commented, "Real transparency is not easy, and it's usually uncomfortable. But to make real progress and be accountable as a company today, you have to 'show your work.' What targets have you set and what are you doing to reach those targets?"

In light of the social justice protests and "S" commitments that business leaders have made to various stakeholders, expectations will continue to grow for companies to "show their work," shortcomings and all. The company's progress on these ESG issues—from employee well-being to addressing social justice issues and climate risk—will be front and center for stakeholders as we head into a challenging recovery and a new reality.

## Understand how technology is impacting the finance organization's talent, efficiency, and value-add.

With COVID-19, we have seen an acceleration of companies' digital transformation efforts. Technology changes also present important opportunities for finance to reinvent itself and add greater value to the business. As audit committees monitor and help guide finance's progress in this area, we suggest three areas of focus:

— Recognizing that much of finance's work involves data gathering, what are the organization's plans to leverage robotics and cloud technologies to automate as many manual activities as possible, reduce costs, and improve efficiencies?

— Understand how the finance function is using data analytics and artificial intelligence to develop sharper predictive insights and better deployment of capital. The finance function is well positioned to guide the company's data and analytics agenda and to consider the implications, opportunities, and risks of new transaction-related technologies, from blockchain to crypto-currencies. As historical analysis becomes fully automated, the organization's analytics capabilities should evolve to include predictive analytics, an important opportunity to add value.

— As the finance function combines strong analytics and strategic capabilities with traditional financial reporting, accounting, and auditing skills, its talent and skill-set requirements must change accordingly. Is finance attracting, developing, and retaining the talent and skills necessary to match its evolving needs? In this environment, it is essential that the audit committee devote adequate time to understand finance's transformation strategy.

## Help ensure that internal audit remains focused on the most critical risks, including risks posed by COVID-19.

Is our internal audit plan risk-based and flexible and does it adjust to changing business and risk conditions? This is an increasingly common question that chief audit executives are asked by the audit committee. While a global pandemic was perhaps not on internal audit's list of likely risk events as we headed into 2020, audit committee members responding to our survey by and large said that internal audit successfully shifted its focus to the critical risks posed by COVID-19—identifying emerging risks, reviewing management's assessment of those risks as well as management's remediation plans and controls for those risks, and assessing incremental fraud risks, as well as return-to-work plans and related risks.[7]

The audit committee should work with the chief audit executive and chief risk officer to help identify the COVID-19-related risks and other risks that pose the greatest threat to the company's reputation, strategy, and operations—such as tone at the top and culture, legal/regulatory compliance, incentive structures, cybersecurity and data privacy, ESG risks, and global supply chain and outsourcing risks. Ask again whether the audit plan is risk-based, flexible, and can adjust to changing COVID-19 and other business and risk conditions. What's changed in the operating environment? What risks are posed by the company's digital transformation and the company's extended organization—sourcing, outsourcing, sales, and distribution channels? Is the company sensitive to early warning signs regarding safety, product quality, and compliance? What role should internal audit play

[5] State Street Global Advisors, "CEO's letter on our 2020 Proxy Voting Agenda," January 28, 2020. State Street employs a proprietary rating system called R-Factor™ that leverages the SASB framework and draws on data from four providers.

[6] A Fundamental Reshaping of Finance, Larry Fink's letter to CEOs, BlackRock, January 2020.

[7] KPMG Audit Committee Institute, Challenges presented by COVID-19, October 5, 2020.

in auditing the culture of the company? Set clear expectations and help ensure that internal audit has the resources, skills, and expertise to succeed—and help the chief audit executive think through the impact of digital technologies on internal audit.

### Sharpen the focus on the company's ethics, compliance, and whistle-blower programs, recognizing the increased pressure on employees.

The reputational costs of an ethics or compliance failure are higher than ever, and COVID-19 has increased the risk of such a failure, particularly given the changed control environment, increased fraud risk due to employee financial hardship, and the pressure on management to meet financial targets. Fundamental to an effective compliance program is the right tone at the top and culture throughout the organization, which supports the company's strategy, including its commitment to its stated values, ethics, and legal/regulatory compliance. This is particularly true in a business environment made more complex by COVID-19, and as companies move quickly to innovate and capitalize on opportunities in new markets, leverage new technologies and data, and engage with more vendors and third parties across increasingly complex supply chains. Coupled with the challenging global regulatory environment—the array of data privacy, environmental, healthcare, financial services, and consumer protection regulations, as well as the Foreign Corrupt Practices Act and the U.K. Bribery Act—compliance risks and vulnerabilities will require vigilance.

Closely monitor the tone at the top and culture throughout the organization with a sharp focus on behaviors (not just results) and yellow flags. Is senior management sensitive to the human resource issues stemming from COVID-19, particularly the pressures on employees (in the office and at home), employee health and safety, employee productivity, engagement and morale, and normalizing work-from-home arrangements? In a crisis of this magnitude, leadership and communications are key, and understanding, transparency, and compassion are more important than ever. Does the company's culture make it safe for people to do the right thing? Help ensure that the company's regulatory compliance and monitoring programs are up to date, cover all vendors in the global supply chain, and clearly communicate the company's expectations for high ethical standards. Focus on the effectiveness of the company's whistle-blower reporting channels and investigation processes. Does the audit committee see all whistle-blower complaints and receive reports on how they are handled? If not, what is the process to filter complaints that are ultimately reported to the audit committee? As a result of the radical transparency enabled by social media, the company's culture and values, commitment to integrity and legal compliance, and its brand reputation are on full display. ■

# Financial reporting and auditing update

## 2020 AICPA Conference highlights

The AICPA hosted its annual Conference on Current SEC and PCAOB Developments on December 7–9, 2020. The conference featured speakers from regulators, standard setters, preparers, auditors, investors, and others, including SEC Chief Accountant Sagar Teotia, FASB Chair Richard Jones, and PCAOB Board members.

An overarching theme of the conference was how the accounting profession is tackling the challenges posed by COVID-19 while continuing to provide high-quality financial information to investors. Amidst these challenges, speakers emphasized that preparers and auditors must continue to apply the existing accounting and auditing guidance and comply with all professional standards. Members of the SEC, PCAOB, and FASB also provided highlights of their 2020 regulatory and standard-setting activities.

Highlights from the conference included:

— **Financial reporting effects of COVID-19**. Speakers addressed the effects of COVID-19 on internal control over financial reporting, financial statement disclosures, and non-GAAP measures.

— **Applying the most challenging accounting standards**. The FASB chair and technical director made observations about and expressed their views on applying the revenue, leases, and credit losses standards, and on some of their other standard-setting efforts. Members of the SEC's Office of the Chief Accountant provided insights on consultations they have received related to reference rate reform, revenue, leases, goodwill, consolidations, equity method of accounting, and consideration received from a vendor.

— **Important developments in auditing**. The PCAOB Board members and staff discussed audit challenges related to COVID-19, observations related to critical audit matters, new requirements for auditing accounting estimates and using the work of specialists, and what to expect from the PCAOB in 2021.

— **Significant SEC developments**. The SEC staff discussed their most significant enforcement and rulemaking activities from 2020, including independence matters.

## COVID-19 year-end reporting reminders

Because of the breadth and scale of COVID-19-related events, most companies have felt some impact and must consider the effects of COVID-19 in preparing their 2020 financial statements. In addition to the key messages on COVID-19 highlighted at the 2020 AICPA Conference, here are some other considerations for companies as they enter the 2020 reporting season:

— **Going concern and other disclosure considerations.** For many companies, a detailed going concern analysis may not have been necessary before COVID-19 due to a history of profitability, ready access to financial resources, and an absence of significant short-term obligations. However, COVID-19 has negatively affected many companies' financial performance, liquidity, and cash flow projections. This uncertainty may necessitate a closer look at whether "substantial doubt" has been raised or exists when the financial statements are issued. Companies may also need to consider whether the effects of the pandemic have triggered other disclosure requirements, including those related to loss contingencies, risks and uncertainties, and subsequent events.

- **Asset impairment.** As part of their overall analysis of the financial reporting effects of COVID-19, companies may need to assess the recoverability of goodwill and other assets, including receivables and contract cost assets, inventory, indefinite-lived intangible assets, long-lived assets (including lease right-of-use assets), equity method investments and deferred tax assets. Companies also will need to reevaluate the inputs used in their impairment analyses, including revisions to expected future cash flows. Depending on the outcome of these analyses, they may be required to make additional disclosures.
- **Economic aid and relief.** Companies might have received economic aid in 2020 under the CARES Act or another government relief program and/or taken advantage of certain relief from US GAAP requirements. Companies should carefully analyze the accounting implications and disclose these unique events, transactions, and accommodations in their financial statements.
- **Non-GAAP measures.** The SEC recently stated that companies will consider their specific facts and circumstances when evaluating the need for non-GAAP adjustments in their disclosures. Non-GAAP measures should be presented in a way that is not misleading. Additionally, where specific amounts are disclosed, companies should provide context for how the amounts were determined to help investors understand the basis for the determination. When disclosing non-GAAP metrics that have been adjusted for COVID-19 impacts, companies should show metrics that present the positive and negative effects when adjusted.
- **Remote work environment.** Companies should consider the effect (or lack thereof) of the remote work environment on their business operations, processes, and controls.

**Other accounting considerations.** Other areas that have been particularly impacted by COVID-19-related events and that may require accounting analysis and expanded disclosure include debt classification and modifications, loan concessions and other contract modifications, transaction price estimates and customer collectibility, and lease accounting. Further, the impacts of COVID-19 may necessitate additional disclosures beyond those explicitly required by the financial reporting framework to achieve fair and transparent presentation.

For more detail about these and other financial reporting and auditing issues, see the KPMG *Quarterly Outlook*, *SEC Issues & Trends: 2020 AICPA Conference on Current SEC and PCAOB Developments*, and *On the 2021 audit committee agenda*. ■

# Race and accountability in the boardroom

The wave of protests and social unrest following the death of George Floyd and others, along with the detrimental effects of COVID-19 and the economic downturn disproportionately affecting employees and communities of color, are driving a national dialogue and heightened consciousness of systemic racism and inequities. During a September 24 BLC webcast, panelists discussed the pivotal question facing corporate America: What's different this time?

This intensified awareness is driving critical conversations in boardrooms today: Is the company doing enough—using its financial resources, making its views known to policy makers, engaging in public/private partnerships—to make real and lasting changes to combat systemic bias and racism? Is the company leading by example—"walking the walk"—by driving diversity, equity, and inclusion throughout the business, including in the boardroom?

"These are not new questions," noted Stephen Brown, KPMG BLC senior advisor. "But the events of 2020 have clearly given diversity and racial justice a new urgency."

"We'll see how all of this unfolds," Gwen Houston, former chief diversity officer for several Fortune 100 companies and head of GM Houston Consulting, said during a September 24 BLC webcast. "What I think is different this time is the depth of introspection across corporate America and the attention to the lack of diversity in this day and age."

## Little progress, mounting pressure

In recent interviews, CEOs, chief diversity officers, board members, and others have acknowledged the painful reality that the country—and corporate America—have not made enough progress and there is much work to be done. Indeed, Houston notes that the number of Black CEOs among the Fortune 500 has actually declined in recent years. And a recent report indicates that only 4 percent of directors in the Russell 3000 are Black and less than 2 percent are Hispanic.[1]

Headlines such as "CEOs Talk Social Justice, and How They Can Do Better," "Corporations Have Failed Black America," and "U.S. Businesses Must Take Meaningful Action Against Racism" point to the soul–searching that many companies have been doing. Watching, listening, and acknowledging the pain that Black Americans and communities of color are suffering is imperative, and speaking out with statements of concern and support matters. It is clear, however, that employees, customers, investors, and communities expect companies to help drive real, lasting change—to back up their statements with action and to demonstrate progress, starting with getting the company's own house in order.

"The situation we're in is not an event, it's a progression," said Dane Holmes, CEO of Eskalera, a technology start-up that uses data analytics to help companies drive diversity and inclusion. "Companies have to change their mindset from crisis and reaction mode to long-term planning mode."

[1] ISS Analytics, U.S. Board Diversity Trends in 2019, May 2019.

## Actions to help drive progress and accountability

To that end, the webcast panelists discussed a number of considerations to help drive diversity and systemic change:

— **Clearly commit** to building the company's pipeline of diverse employees and board members. This commitment should come directly from the CEO, and employees should see it in the CEO's actions and follow–through.

— **Define diversity and consider setting aggressive goals** at all levels, including leadership and senior management, business unit heads, middle ranks, and internships. "Diversity metrics should be in there with all the other KPIs as a business performance measure to hit—not simply a nice-to-have or extra credit."

— Consider linking diversity goals to compensation to help measure progress and **hold the CEO and leadership team accountable**. "Diversity incentives have to start at the top, where the sustainable, long-term decisions are being made."

— Consider robust tracking of diversity metrics—and **get underneath the data**. Disaggregating the data can provide a clearer picture. "Good diversity and representation numbers don't necessarily add up to an inclusive culture."

— **Consider using the Diverse Slates/Rooney Rule[2] as a baseline** for a diverse slate of candidates, and be skeptical if told that lack of progress is due to a lack of qualified candidates. "That can be an excuse for insufficient recruitment efforts." To that end, understand the extent of a **recruiter's connectivity to diverse communities** and ability to tap a wider pool of diverse candidates.

— For roles that require managing people, as part of the recruiting process, consider, where appropriate, having **job candidates provide a written statement on how they value diversity and inclusion**, and why. "During the interview, ask the candidate to elaborate on their views; that's where authenticity will show."

— When choosing **vendors/consultants**, consider their track records on diversity. Do the company's third-party providers track and periodically report on the inclusion of people of color and other underrepresented groups on their client teams? "Be clear with vendors what your company's standards and priorities are."

— Ask management to conduct a **diversity risk assessment** to better understand the strategic, legal, talent-related, and reputational risks posed by the company's diversity profile. At one company, such a risk assessment helped the board understand the potential for, and take proactive steps to avoid, a human capital–related class-action lawsuit in which a peer company was a defendant. At another company, the assessment revealed that its broadest consumer base was not White, as it thought, but Black and Latinx consumers.

— Tell the company's **diversity story** in detail. "This is a difficult story for most companies to tell—but an honest picture of the company's progress and the goals it's striving for are important in terms of credibility and confidence."

— Redouble **employee training** to combat bias. Such training should be provided in the context of the company's culture, values, and emphasis on inclusive leadership. "Make sure that facilitators are well-trained—this is an emotional issue that's not easy to navigate."

— Reassess effectiveness of **the company's voice** in the public sphere. To what extent is the company advocating for social justice programs versus taxes and regulatory issues? "One question we had to ask ourselves was, are we supporting legislators who agree with our views on diversity and racial justice?"

— Understand the risk of racial and other **bias in the company's data**, particularly as COVID-19 accelerates the use of data analytics and artificial intelligence.

## It's about leadership and long-term performance

A sustained commitment from leadership is critical. Many companies have released statements or taken stances on Black Lives Matter, being an ally for diversity and inclusion, and combatting systemic racism. Yet, as Margaret Huang, president and CEO of the Southern Poverty Law Center, has emphasized, "It's not a temporary battle. If you're going to take these issues on, it's not because it's a moment and you think you can do a press statement or a couple of steps and then move on. This is the work. This is a lifetime of work. If you're going to get into it, you have to be absolutely committed that you're going to do it internally in your organization and externally in the work that you're doing."[3]

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[2] The Rooney Rule, named after Dan Rooney, former owner of the Pittsburgh Steelers and former chair of the NFL's diversity committee, started as an NFL policy that requires teams to interview minority candidates for head coaching and senior operation jobs. It doesn't give preference to those candidates or impose a quota.

[3] Janeen Williamson and Natasha Shields, "What Can Brands Do To Foster Social Justice? The Southern Poverty Law Center Has Ideas," Atlantic57.com, August 4, 2020.

"This needs to be led from the very top," said Houston. "The message is only as important as the messenger. CEOs have to step up. This work has to be central to a company's culture and viewed as mission-critical and driving the long-term success of the business."[4]

Ultimately, it's an economic argument, said Victor Arias of Diversified Search. "Where is the growth of your business coming from in the future? Who are those consumers? Who are those stakeholders?"

Indeed, the economics of diversity continue to move front and center. A recent study estimates that since 2000, U.S. gross domestic product lost $16 trillion as a result of discrimination against African Americans in a range of areas, including in education and access to business loans.[5]

Brown noted that investors and other corporate stakeholders will be watching closely whether companies' statements of commitment and support for diversity, equity, and inclusion are followed up by action. "What's also different this time is the sustained scrutiny and pressure for progress that I'm sure we'll see."

*For more on how boards are tackling diversity, equity, and inclusion, listen to the KPMG Board Leadership webcast Race and Accountability in the Boardroom—a conversation with Gwen Houston, Dane Holmes, and Victor Arias, Jr.* ■

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

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[4] Knowledge at Wharton, "Why Inclusion Starts in the C-suite," August 17, 2020.

[5] Adedayo Akala, "Cost of Racism: U.S. Economy Lost $16 Trillion Because Of Discrimination, Bank Says." NPR, September 23, 2020.

# Getting better at seeing ahead

**J. Peter Scoblic**

The deep and ongoing impact of COVID-19 has clearly sharpened the focus in boardrooms today on the company's risk management and forecasting efforts—identifying and modeling critical operating and strategic risks that are in view or "just around the corner." But the upending events of the past 12 months have also highlighted in stark relief the imperative—and the difficulties—of peering further into the future, where uncertainty and ambiguity prevail.

From climate change, artificial intelligence (AI), and evolving consumer expectations, to the growing influence of China and the rise of stakeholder capitalism, grappling with the megatrends and uncertainties potentially affecting the company's long-term success can quickly move beyond probabilities and into the realm of possibilities and the imagination. "Often, though not always, the further out you go, the greater the uncertainty and the more difficult it gets," says J. Peter Scoblic, cofounder of Event Horizon Strategies, former executive editor at *Foreign Policy,* and senior fellow in the International Security Program at New America.

It's clear to Scoblic that organizations aren't devoting enough time or resources to thinking about the future. "Last year, we saw the future come rushing at us," he notes, suggesting that companies need to be adept not only at navigating near-term risk, but also at imagining a range of scenarios that could affect the company's long-term future.

In this conversation with the KPMG BLC, Scoblic shared his thoughts about how organizations can become more effective at envisioning the future and integrating future-thinking into near-term decision-making.[1] Among the key elements: establishing a "strategic foresight function" that is free to imagine the future and challenge the company's strategic assumptions and inherent biases; instilling a forward-thinking culture and mindset; making scenario planning an ongoing, iterative process; and using signposts to monitor and regularly calibrate the company's vision of the future.

## At a glance

To think about the future more systemically, consider:

- Establishing a "strategic foresight function" (distinct from strategic planning) that is free to imagine the future and challenge the company's strategic assumptions
- Instilling a forward-thinking culture and mindset, whereby future scenarios factor into current thinking and decision-making
- Making scenario planning an ongoing, iterative process
- Using "question clusters" to focus on disconfirmatory evidence and combat the allure of a compelling narrative that may no longer be valid
- Creating signposts to monitor and regularly calibrate the company's vision of the future.

[1] Also see "A Better Crystal Ball: The Right Way to Think About the Future," J. Peter Scoblic and Philip E. Tetlock, Foreign Affairs, November/December 2020.

**BLC: When it comes to "seeing ahead," what do you see organizations struggling with the most?**

**Scoblic:** Typically, there is not enough emphasis placed on uncertainty and long-term scenario planning, and there's too much emphasis placed on near-term risks. While both pertain to the company's possible futures—and the optimal approach is to try to blend the two—gauging uncertainty is far more subjective and more difficult, which is probably why it gets less attention.

Last year, we saw the future come rushing at us. So, to the extent that companies make the future— particularly the longer term—part and parcel of their everyday work, I think they are much better off. To the extent that they account for uncertainty, they're better off. Envisioning what the future might look like once a year at a strategic retreat, and assuming that the future will stay still while the company moves toward it, is where companies tend to falter.

**BLC: In your recent article in *Foreign Affairs,* you write: "The greatest barrier to a clearer vision of the future is not philosophical but organizational." How can boards help companies establish an appropriate organizational capability for scenario planning and envisioning the future?**

**Scoblic:** The first thing that boards should do is combat a culture of short-term thinking. Such a mindset emerges for several reasons. Corporations focus on the short term because there's less uncertainty—the returns on actions that you take in the short term are more visible, more proximate, and more tangible. There are incentives, whether focused on quarterly earnings or share price or other goals. There's a cultural hurdle to get over.

**"Scenario planning can help us map uncertainty, so that we can get a better grasp on the range of plausible futures."**

***—J. Peter Scoblic, cofounder, Event Horizon Strategies***

Then, from an organizational standpoint, help management establish a strategic foresight function. It's important to distinguish strategic foresight from strategic planning. In planning, you come up with a one-, three-, five-year plan, often based on extrapolation.

A foresight function is an adjunct to planning and addresses the uncertainty of the longer-term future, incorporating forecasting to help mark or anticipate signposts along the way that give you a sense of which "uncertain future" you're headed toward. If you establish a function like this, you've got to give it enough room away from operational demands so that it does not get subsumed into the daily world of work. At the same time, it needs to have close enough proximity to decision-makers that it actually makes a difference, and it doesn't end up just producing "shelf-ware" in the form of glossy reports or binders.

The function should establish the things that might prevent the company from reaching its long-term strategic goals. "Here is the range of plausible futures that we might be headed toward, and in not all of them or perhaps even in any of them does the preferred future that we want manifest."

**BLC: One caution that you raise is the bias/irrationality that can be triggered by "the compelling nature of a good narrative." How can boards challenge "the seductiveness of a particularly good narrative" that could undermine decision-making?**

**Scoblic:** As soon as we tell ourselves a story about the future and what it's going to look like or what we want it to look like, we start seeing evidence of it emerging everywhere. Stories trigger a whole host of judgmental biases. What the research psychologists would say happens is that a story we tell ourselves about the future becomes a focal hypothesis. It's essentially an assumed-to-be-true belief about how the future is going to work out.

Better framing and organization of questions—into what Wharton Professor Philip Tetlock calls question clusters—can help the board better evaluate whether the future the company has in mind is materializing or not. Question clusters do this by forcing us to establish markers in advance of what would signal that a future is coming to pass, but also what would signal that it's not. Confirmation bias is a decision-making bias whereby we look for evidence that backs up our preexisting beliefs, and we tend to ignore evidence that doesn't. Question clusters focus us on disconfirmatory evidence.

**BLC: For management, what would you recommend as an exercise or leading practice to help ensure that daily operational demands don't overwhelm their ability to plan or forecast?**

**Scoblic:** If you think of the notion of mental models—the maps we have in our head about how reality works, the relationships between cause and effect, and so on—what scenario planning exercises are very good at is changing mental models and making them more malleable. You can hold a scenario planning exercise, and people will come away not only thinking differently about the future, in the sense that they think what is possible is different than the assumptions that they went in with, but also come out thinking differently in their day-to-day.

Scenario planning seems to affect people whereby they stop thinking that the long term and the short term are competing necessarily, and they are more complementary. Beliefs about the future influence our

actions in the present. As people go about their daily work, they start thinking more about what their actions mean for the long term. It becomes like software running in the background. You're not walking around constantly thinking about the future, or about the long-term future and about future uncertainty, but when you stop to make a decision, especially a difficult-to-reverse decision that may have long-term consequences, it's easier to think about long-term implications.

For this type of thinking to permeate an organization, bring in a wider range of participants to scenario planning exercises. And hold them more frequently than once-a-year. Involve as much of your organization as you can, or at least the decision-making components of your organization, so that they stop thinking of the present and the future as competing.

### BLC: What role do you see technology—data analytics/AI—playing in all of this?

**Scoblic:** There's great potential for using technology in combination with these techniques to aid in the discovery of weak signals of the future, of patterns that are occurring before human beings may notice them. Take the early outbreak of disease, for example. AI or just large swathes of data may enable identification of case trends sooner.

But I think there is danger in believing that the predictive capabilities of AI are all that we need, or that everything that we need is in the data. The feedstock for these things is data from the past. There's no way to account for the uncertainty of the future or the fact that maybe we haven't even conceived of all the things that may come to pass, and so there will never be a substitute for the imagination that goes into scenario planning, and the ability to account for a wide range of plausible futures.

There's a lot of potential for hybrid human/AI interaction to work. But there's just a very strong temptation to say now that we have this technology, we're going to have a much clearer vision of the future. This kind of belief comes in waves, where suddenly new worlds of data or data analysis open up, and people think, "Okay, we've solved the riddle, we can now see the future." And then, of course, surprise inevitably follows.

### BLC: How can companies build robust strategies related to climate change?

**Scoblic:** Climate change poses situations of both risk, which we're already beginning to see and model, and future uncertainty. We know that the planet is warming, and that climate scientists are able to model many ways in which that will manifest—sea-level rise, for example. The models aren't perfect—no model is—but we can still probabilistically state what the impact of climate change will be on a given physical system. Admittedly, given the complexity involved, there will be surprises—it is hard to pin scientific probabilities on specific severe weather events. Still, firms can go a long way toward planning for the physical effects that climate change could have on their business. It is possible to get quite granular about how climate change will affect a business's ability to create value.

The greater business challenge comes in assessing the impact that climate change will have on social, economic, and political systems. That is where uncertainty really enters in. It is very difficult to pin "objective" probabilities on those second- and third-order effects because we've never seen a change of this kind and of this magnitude before. We lack analogies to past experience. So, we are left with far more subjective estimates of possible effects, and we must face the fact that there may be impacts we have not even considered. There is not only uncertainty about the future, but ignorance.

Here, scenario planning can play a useful role. It can help reduce ignorance by providing a structured framework to aid imagination. We may think of potential developments that we hadn't before and consider whether we need to formulate strategy to account for them. And scenario planning can help us map uncertainty, so that we can get a better grasp on the range of plausible futures. The effects of climate change on business are likely to be wide-ranging, and scenario planning helps put boundaries on those uncertainties. It is neither true nor useful to say that anything can happen, and scenario planning puts some guardrails on the road to potential futures. That, in turn, can enable businesses to formulate smarter strategy.

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*Scoblic, a Fellow at Harvard's Kennedy School, was awarded the 2019 Wyss Award for Excellence in Doctoral Research from Harvard Business School. He is a cofounder and principal at Event Horizon Strategies.* ■

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

# Mark your calendar

**Out Leadership Quorum Summit**

*February 2–5, 2021*

Focused on developing LGBTQ+ leaders to serve on corporate boards, this first-of-its-kind talent program will explore topics including the role of the private equity and hedge fund industries in board diversity, how to become a board candidate for early stage and mid-cap companies, and the evolution of recent board diversity initiatives in state regulations, Fortune 500 companies, and organizations around the world.

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## Selected reading

**Investors' annual stewardship reports: Takeaways for boards** *KPMG BLC*

**2020 U.S. Spencer Stuart Board Index** *Spencer Stuart*

**Board demographics reporting guidelines** *Out Leadership*

**Work anywhere: What does it mean for you?** *KPMG LLP*

**Ready, set, IPO: A three-part plan for executive compensation** *Pearl Meyer*

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