KPMG

# Directors Quarterly

**Insights from the Board Leadership Center**

January 2022

## Looking forward: On the 2022 agenda

As we kick off the new year, the global economy continues to be disrupted by COVID-19 and its variants. Concerns about inflation, labor constraints, and supply chain issues persist. Uncertainty has become the norm.

Boards will have their work cut out for them crafting agendas that are flexible enough to allow time for discussion of emerging issues while also addressing an array of oversight issues and must-do's that require focused attention and deeper dives. In this edition of *Directors Quarterly*, we highlight some of the top items for board and audit committee agendas in the year ahead, with trust, transparency, and positioning the company for the future underpinning it all.

Continuing our work to benchmark progress on boardroom diversity, we share takeaways from our latest director survey, as well as findings from our research on the state of African American representation on the boards of public Fortune 1000 companies.

This edition also provides insights from the 2021 AICPA and CIMA Conference on Current SEC and PCAOB Developments, including important reminders heading into the calendar year–end financial reporting season.

We hope you find *Directors Quarterly* helpful as you shape your board and committee agendas for 2022.

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### What's inside

# On the 2022 board agenda

As the country focuses on reopening and companies reposition for the future, it is increasingly clear that resilience—of strategy, the organization, and operating muscle—is proving to be the great differentiator of the pandemic era. From pivoting to "remote everything" and focusing on workforce well-being to deepening digital engagement with customers and recalibrating supply chains, the ability to quickly adapt to dramatic disruptions and dislocations has defined the survivors and thrivers.

The unprecedented events of the past two years have clearly put corporate governance processes, including board oversight, to the test. Demands for action on ESG performance, including climate risk, increased cybersecurity risks (including ransomware attacks), economic and supply chain challenges, a fast-changing regulatory landscape, and other factors impacting the global risk environment will continue to challenge even those boards at the top of their game.

In short, boards are at a pivotal moment. As one director recently observed, the need for today's boards to help their company "reimagine, rethink, and reset is probably a once-in-a-generation opportunity."

Drawing on our research, insights, and interactions with directors and business leaders, we highlight eight issues here for boards to keep in mind as they consider and carry out their 2022 agendas:

- **Deepen the board's engagement in strategy and envisioning the future.**
- **Embed ESG, including climate risk and DEI, into risk and strategy discussions.**
- **Engage proactively with shareholders, activists, and other stakeholders.**
- **Make talent, human capital management (HCM), and CEO succession a priority.**
- **Approach cybersecurity and data privacy holistically as data governance.**
- **Reassess the company's crisis prevention and readiness efforts.**
- **Help set the tone and closely monitor the culture of the organization.**
- **Think strategically about talent and diversity in the boardroom.**

## Deepen the board's engagement in strategy and envisioning the future.

Given the volatile and fluid business environment ahead—managing remote workforces, employee activism, digital transformations and other accelerating megatrends, building more resilient supply chains, and strengthening connections with customers whose behaviors, preferences, and expectations are changing—take time to reassess the board's engagement in strategy. Review the alignment of culture, values, and strategy. And identify specific practices to drive quality boardroom discussions about strategy and the future.

A fundamental question for every board is whether boardroom conversations are, in fact, conversations. Does the board allocate sufficient agenda time to meaningful, two-way discussions between management and the board about forward-looking issues—challenging assumptions and considering scenarios (likely and unlikely)—versus reviewing historical, compliance-related information which, while essential, can crowd out valuable agenda time.

The board's fiduciary role remains oversight, but effective engagement in strategy discussions (which investors expect) increasingly calls for a collaborative mindset: How can the board help management think through the implications of pressing and potentially existential strategic questions and decisions? And is management helping to set the context, providing meaningful materials to the board to prepare directors for those critical conversations and maximize the board's contribution?

In our discussions with lead directors over the past year, a number of elements and practices were highlighted that may be helpful:

— *Encourage management to revisit its strategic planning processes*. Is the process adequate in light of the speed and impact of megatrends—and does it capture the risks and potential disruptions on the horizon? Does the process challenge the validity of key assumptions that the company's strategy and business model are based on? Is it an iterative process—with milestones and opportunities to recalibrate—and does it bring in perspectives from throughout the organization, beyond the inner team?

— *Develop a vivid picture of the future*. This is never an easy undertaking, and it's particularly challenging today, given the level of uncertainty and transformational changes underway. Where are the company's industry and competition (both industry competitors and those in adjacent industries) headed? What might the business look and feel like in 2, 5, or 10 years? Make time for the board to have meaningful "what-if" discussions in a focused and urgent way—including devoting time to less-likely scenarios (without getting overly theoretical). Risks and scenarios related to climate, ESG, human capital, and supply chain should be front and center.

— *Make resilience part of the strategy discussion*. Full resilience is not only the ability to bounce back when something goes wrong; it's also the ability to stand back up with viable strategic options for staying competitive and on the offense.

— *Understand the value of the board's lens*. Management is immersed in running the business, looking around the corner, and staying competitive—as they should be. Board members are likely picking up broader perspectives and signals from their activities—and may be "seeing and hearing things differently than management." Leverage directors fully, as valuable sources of insight and competitive advantage.

## Embed ESG, including climate risk and DEI, into risk and strategy discussions.

How companies address climate change, diversity, equity, and inclusion (DEI), and other ESG risks is now viewed—by investors, research and ratings firms, activists, employees, customers, and regulators—as fundamental to the business and critical to long-term sustainability and value creation. Expect the intense regulatory focus on these issues to continue in 2022.

The clamor for attention to climate change as a financial risk has become more urgent, driven by a confluence of factors, the most visible of which is the accelerating physical impact of climate change—including the frequency and severity of floods, wildfires, rising sea levels, and droughts—as well as concern by many experts that the window for preventing more dire long-term consequences is rapidly closing. Related to climate risk are the "transition risks" that companies face as they work—in conjunction with countries, regulators, and other stakeholders—to reduce reliance on carbon and the impact on the climate. The Task Force on Climate-related Financial Disclosures (TCFD) defines these transition risks as "risks associated with the transition to a lower-carbon economy, the most common of which relate to policy, tax, and legal actions, technology changes, market responses, and reputational considerations." A challenge for boards is to help ensure that these transition risks are addressed by management in its enterprise risk management processes—together with other climate change risks.

Monitoring the rapidly changing legal and regulatory developments regarding climate change is critical as regulators and policy makers globally are placing greater demands on companies to take action—as evidenced by the U.S. reentry into the Paris Agreement and pledge to cut emissions in half by 2030, and the COP26 summit, which brought parties together to accelerate action toward the goals of the Paris Agreement and the UN Framework Convention on Climate Change. The SEC is expected to propose disclosure rules on climate change, HCM (including diversity), and cybersecurity risk governance in early 2022.

The 2021 proxy season, most notably for boards, highlighted shareholders' increasing willingness to act, particularly on climate and a broad range of ESG and DEI issues. In numerous instances, shareholders voted against directors when they believed that companies were not responsive to critical issues such as climate risk, diversity, and HCM. The shareholder proposals of 2021 and boards' responses to them were clearly reflective of the times, with workforce and environmental/climate issues front and center. The push for better and more transparent DEI efforts has broadened beyond a focus on boardroom gender diversity to include diversity of race, ethnicity, and experience at all levels of an organization.

As SEC Commissioner Allison Herren Lee stated in June, "This proxy season is just the latest affirmation of a sea change on climate and ESG. It occurs against the backdrop of the U.S. reentry into the Paris Agreement … and a broad global reckoning with the need for enhanced transparency on sustainability. It also occurs in the midst of ever-more-powerful signals from major institutional investors of their commitment to sustainability. Finally, it occurs as the SEC considers potential rulemaking to improve climate and other ESG disclosures for investors.

These developments place ever-greater responsibility on companies, and therefore boards, to integrate climate and ESG into their decision-making, risk management, compensation, and corporate transparency initiatives."[1]

To that end, several fundamental questions should be front and center in boardroom conversations about the company's ESG journey. After determining which ESG issues are material to the company, assess which of these issues are of strategic significance. How is the company embedding them into core business activities (strategy, operations, risk management, incentives, and corporate culture) to drive long-term performance? Is there a clear commitment and strong leadership from the top, and enterprise-wide buy-in?

Oversight of these risks and opportunities is a significant challenge, involving the full board and multiple board committees. For example, elements of climate, ESG, and DEI oversight likely reside with the nominating and governance, compensation, and audit committees—and other committees may have responsibilities as well. Overlap is to be expected, but this puts a premium on information sharing and communication and coordination among committees. It also requires that committees have the expertise to oversee the issues delegated to them.

### Engage proactively with shareholders, activists, and other stakeholders.

Given the intense investor and stakeholder focus on climate risk, ESG, and DEI, particularly in the context of long-term value creation, engagement with shareholders and stakeholders should be a priority. Institutional investors and stakeholders are increasingly holding boards accountable for company performance and are continuing to demand greater transparency, including direct engagement with independent directors on big-picture issues like strategy and ESG. Indeed, transparency, authenticity, and trust are not only important to investors, but increasingly to employees, customers, suppliers, and communities—all of whom are holding companies and boards to account.

The board should request periodic updates from management about the company's engagement activities:

- Does the company know, engage with, and understand the priorities of its largest shareholders and key stakeholders?
- Are the right people engaging with these shareholders and stakeholders—and how is the investor relations (IR) role changing (if at all)?
- What is the board's position on meeting with investors and stakeholders? Which independent directors should be involved?

In short: Is the company providing investors and stakeholders with a clear, current picture of its performance, challenges, and long-term vision—free of "greenwashing"? (Investors, other stakeholders, and regulators are increasingly calling out companies and boards on ESG-related claims and commitments that fall short—and all indications are that they will continue to do so.)

As reflected in 2021 proxy voting trends, strategy, executive compensation, management performance, climate risk, other ESG initiatives, DEI and HCM, and board composition and performance will remain squarely on investors' radar during the 2022 proxy season. We can also expect investors and stakeholders to focus on how companies are adapting their strategies to address the economic and geopolitical uncertainties and dynamics shaping the business and risk environment in 2022.

Having an "activist mindset" is as important as ever—particularly given the convergence of ESG and more traditional hedge fund activism highlighted by the successful proxy fight conducted by Engine No. 1 against a major oil company. By linking climate and environmental issues to profits and long-term value creation, Engine No. 1 created a compelling investment thesis that garnered the support of major institutional investors. Engine No. 1 won three board seats, providing its independent nominees with the ability to influence the strategic direction of the company. The key to Engine No. 1's success and winning institutional shareholder support appears to be its linkage of ESG practices and data to long-term value creation.

As stated in Engine No.1's Total Value Framework report:

> "We developed our Total Value Framework to address the current deficiencies in ESG data and to help investors generate lasting impact on corporate behavior and robust long-term financial returns—not just the warm glow of a 'pure' portfolio.
>
> Through the Total Value Framework, we attempt to measure the value companies create or destroy for both shareholders and stakeholders—their employees, customers, communities, and environment—as well as on the connection between the two groups. Instead of ESG scores and ranks, which in effect constitute little more than emojis and are as difficult to incorporate into spreadsheets or algorithms, we try

[1] Speech by SEC Commissioner Allison Herren Lee, "Climate, ESG, and the Board of Directors: 'You Cannot Direct the Wind, But You Can Adjust Your Sails,'" June 28, 2021.

where possible to quantify the impact in dollars. We use independent sources and estimates to assess the firm-level costs of emissions, resource use, waste, social practices, and a host of other ESG factors.

Armed with this new data, we can proceed to focus on how the value a company delivers to its stakeholders affects the value it is then able to impart to its shareholders. This forces us to examine drivers like potential regulation, changes in customer or employee preferences, technological disruption, and other relevant contributors to a company's risk or growth."

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

The events of 2020–2021 further highlighted the strategic importance of HCM issues—including employee and supply chain health and safety issues so critical to the company's performance and reputation. Institutional investors have been increasingly vocal about the importance of human capital and talent development programs and their link to strategy—including calling for more engaged board oversight and enhanced disclosure of HCM-related metrics. In August 2020, the SEC adopted a new principles-based disclosure rule that 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. There was general dissatisfaction with companies' HCM disclosures in their 2021 filings, particularly the lack of quantitative data.

In addition to monitoring SEC rulemaking developments in this area, boards will want to discuss with management the company's HCM disclosures in the 2021 10-K—including management's processes for developing related metrics and controls ensuring data quality—and help ensure that the disclosures demonstrate the company's commitment to critical human resources issues.

In 2022, we can expect continued scrutiny of how companies are adjusting their talent development strategies. The challenge of finding, developing, and retaining talent amid a labor-constrained market has created a war for talent. Does the board have a good understanding of the company's talent strategy and its alignment with the company's broader strategy and forecast needs for the short and long term? Which roles throughout the organization are mission critical, and what are the challenges keeping those roles filled with engaged employees? Which talent categories are in short supply and how will the company successfully compete for this talent? Does the talent strategy reflect a commitment to DEI at all levels? More broadly, as millennials and younger employees—who increasingly choose employers based on alignment with their own values—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?

Pivotal to all of this is having the right CEO in place to drive culture and strategy, navigate risk, and create long-term value for the enterprise. The board should ensure that the company is prepared for a CEO change—whether planned or unplanned, on an emergency interim basis or permanent. CEO succession planning is a dynamic and ongoing process, and the board should always be focused on developing a pipeline of potential CEO candidates as well as all other C-suite positions. (Succession planning should start the day a new CEO is named.)

How robust are the board's succession planning processes and activities? Which board committee has responsibility to review the plans (at least once per year, but likely more often in these uncertain times)? Are succession plans in place for other key executives? How does the board get to know the high-potential leaders two or three levels below the C-suite—especially in a work-from-home environment when office visits and board-executive in-person meetings may not be feasible?

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

The rapid shifts that companies have made during the pandemic to keep their businesses up and running—remote work arrangements, supply chain adjustments, and increased reliance on online platforms—have been a boon to organized crime, hacktivists, and nation-states. Cyberattacks of all types proliferated during the pandemic, highlighting the far-reaching implications for supply chains and operations, as well as the ongoing cybersecurity challenge facing companies.

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 to show critical risks, and more robust conversations with management. Despite these efforts, the acceleration of digital strategies, remote and hybrid work models, increased regulatory scrutiny of data privacy, and the growing sophistication of cyberattackers, all point to the continued cybersecurity challenge ahead.

As we've noted, data governance overlaps with cybersecurity, but it's broader. Data governance includes compliance with industry-specific privacy laws and regulations, as well as privacy laws and regulations that govern how personal data—from customers, employees, or vendors—is processed, stored, collected, and used.

Data governance 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 and customer expectations as to how their data will be used. Managing this tension poses significant reputation and trust risks for companies and represents a critical challenge for leadership.

To oversee cybersecurity and data governance more holistically:

- 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.

### Reassess the company's crisis prevention and readiness efforts.

The litany and severity of crises that companies have found themselves facing in recent years looms large, with crisis prevention and readiness now featuring more prominently than ever in boardroom conversations. Crisis prevention goes hand in hand with good risk management—identifying and anticipating risks, and putting in place a system of reporting and controls to help prevent or mitigate the impact of such risk events.

We're clearly seeing an increased focus by boards on cultural risks as well as key operational risks across the extended global organization—e.g., supply chain and outsourcing risks, information technology and data security risks, etc. Does the company understand its critical operational risks, including mission-critical company and industry risks? What's changed in the operating environment? Has the company experienced any control failures, and if so, what were the root causes? Is management sensitive to early warning signs regarding safety, product quality, and compliance?

Periodically reassess the clarity and appropriateness of risk oversight responsibilities among the board's committees—being mindful to not overload the audit committee's agenda, and recognizing the importance of good communication and coordination among committees, as certain risks likely touch multiple committees.

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

A final, important reminder from the COVID-19 pandemic experience: While management should keep the board apprised throughout a crisis, the board should avoid information requests that unduly add to management's workload and potentially distract the CEO and management team from mission-critical activities.

### Help set the tone and closely monitor the culture of the organization.

The events of 2020–2021 have increased the risk of ethics and compliance failures, particularly given the increased 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 human resource issues—particularly the pressures on employees (both in the office and at home), employee health, safety, and well-being, 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 sexual harassment, price gouging, aggressive sales practices, and other wrongdoing continue to put corporate culture, leadership, and incentives front and center. With the near-instantaneous speed of social media, corporate crises (particularly when self-inflicted) are hitting corporate reputations fast and hard, with investors, regulators, and others increasingly 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 focus on the tone set by senior management and zero tolerance for conduct that is inconsistent with the company's values and ethical standards, including any "code of silence" around such conduct. Be sensitive to early warning signs, and verify that the company has

robust whistle-blower and other reporting mechanisms in place, and that employees are not afraid to use them. Closely monitor the reporting systems to understand how claims are addressed/resolved and identify trends. If the company has a sizable workforce and few or no claims, the board should dig deeper.

Understand the company's actual culture (the unwritten rules versus those posted on the breakroom wall); use all the tools available—surveys, internal audit, hotlines, social media, virtual town halls as well as walking the halls, and visiting facilities—to monitor the culture and see it in action. Recognize that the tone at the top is easier to gauge than the mood in the middle and the buzz at the bottom. How does the board gain visibility into the middle and bottom levels of the organization? Make sure that incentive structures align with culture and strategy and encourage the right behaviors. Take a hard look at the board's own culture for signs of groupthink or discussions that lack independence or contrarian voices. Focus not only on results, but the behaviors driving results.

### Think strategically about talent and diversity in the boardroom.

Boards, investors, regulators, and other stakeholders are increasingly focused on the alignment of board composition with the company's strategy—with diversity front and center.

Indeed, the increased level of investor engagement on this issue 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 innovations and digital changes, climate and ESG risks, cyber risk, and global volatility requires a proactive approach to board-building and board diversity—of skills, experience, thinking, gender, and race/ethnicity.

While boards have made progress on diversity, change has been slow. According to Spencer Stuart's 2021 U.S. Board Index (released in October), 47% of the new directors added during the 2021 proxy season are Black/African American, Hispanic/Latino/a, Asian, American Indian/Native Alaskan, and multiracial directors, largely driven by an increase in the recruitment of Black/African American directors. And 43% of new directors are women, a decline from 47% last year. However, due to low boardroom turnover, the addition of new directors from underrepresented groups has had little impact on the overall diversity of S&P 500 boards. Just 21% of all S&P 500 directors in 2021 are from these minority groups. And women now represent 30% of all S&P 500 directors—the most ever—despite representing close to half the new director classes the last several years.[2]

Spencer Stuart's 2021 U.S. Board Index also confirms that board turnover remains low (0.94 new directors per board annually). Average independent director tenure has declined only slightly to 7.7 years, down from 8.7 in 2011, while average director age has risen slightly in the last decade (to 63.1). 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 the most common mandatory retirement age is 75, with many boards expressly permitting exceptions to the policy.[3]

Expect continued legislative and regulatory action on board composition and diversity. For example, in 2021, the SEC approved the new board diversity disclosure requirements for Nasdaq-listed companies—requiring that company boards meet certain diversity requirements or explain in writing why they have failed to do so—and Chair Gensler said the rules will "allow investors to gain a better understanding of Nasdaq-listed companies' approach to board diversity, while ensuring that those companies have the flexibility to make decisions that best serve their shareholders."

Board composition, diversity, and renewal should remain a key area of board focus in 2022, as a topic for communications with the company's institutional investors and other stakeholders, enhanced disclosure in the company's proxy, and most fundamentally positioning the board strategically for the future.■

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[2] "2021 U.S. Spencer Stuart Board Index," Spencer Stuart, October 2021.

[3] Ibid.

**Find the full *On the agenda* series from the KPMG Board Leadership Center online at kpmg.com/us/blc.**

# On the 2022 audit committee agenda

Emerging from two years of pandemic-driven crisis and disruption, we continue to see how important trust and transparency are—not only to the functioning of the capital markets, but also to customer relationships, brand reputation, and the health and well-being of employees. For shareholders—and, increasingly, from a broader stakeholder perspective—much of that trust and transparency is grounded in the quality of the company's financial reporting and disclosures and the story they tell. To that end, the audit committee's oversight role has perhaps never been more important or more challenging.

The crises of 2020–21 and disruptions they've triggered—from accelerating technology transformations to upending long-standing "norms" of the workplace, business models, and the economy—have added significant stress and strain to financial reporting processes and the risk and control environment. That pressure is likely to continue given the demands for more and better climate and ESG reporting, increased cybersecurity risks and ransomware attacks, a fast-changing tax and regulatory landscape, and other factors impacting the global risk environment—including the direction of COVID-19.

Drawing on our research, insights, and interactions with audit committees and business leaders, we've highlighted eight issues to keep in mind as audit committees consider and carry out their 2022 agendas:

— **Stay focused on financial reporting and related internal control risks—job number one.**

— **Monitor the SEC's rulemaking activities on climate and other ESG disclosures and clarify the audit committee's related oversight responsibilities.**

— **Stay apprised of global tax developments and risks and recognize that tax has become an important element of ESG.**

— **Help sharpen the company's focus on ethics and compliance.**

— **Reinforce audit quality and set clear expectations for the external auditor.**

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

— **Help ensure that internal audit is focused on the company's critical risks.**

— **Make the most of the audit committee's time together.**

## Stay focused on financial reporting and related internal control risks—job number one.

It's clear from our conversations with audit committee members that overseeing major risks on the audit committee's agenda beyond the committee's core oversight responsibilities (financial reporting and related internal controls, and oversight of internal and external auditors) is increasingly difficult. Aside from any additional agenda items (such as climate and ESG risks), the risks that many audit committees have had on their plates for some time—cybersecurity and IT risks, supply chain and other operational risks, legal and regulatory compliance—have become more complex, as have the audit committee's core responsibilities. Reassess whether the committee has the time and expertise to oversee these other major risks. Do climate and other ESG issues and cybersecurity risks require more attention at the full-board level—or the focus of a separate board committee? The pros and cons of creating an additional committee should be weighed carefully; but considering whether a finance, technology, risk, sustainability, or other committee would improve the board's effectiveness—and whether the board has the resident skill sets to oversee these issues—can be a healthy part of the risk oversight discussion.

As the financial reporting, accounting, and disclosure impacts of COVID-19 continue to unfold in 2022, key areas of focus for the company's 2021 10-K and 2022 filings should include:

— *Forecasting and disclosures.* Due to the uncertain trajectory of COVID-19 and the economy—and the extensive use of forward-looking information in financial statements and SEC filings—COVID-related disclosures remain a top area of focus. At the same time, the strains on supply chains will make financial forecasting even more difficult. Among the key areas requiring audit committee attention: Disclosures regarding the current and potential effects of COVID-19 (e.g., risk factors, MD&A, liquidity, results of operations, and known trends and uncertainties); preparation of forward-looking cash-flow estimates; impairment of nonfinancial assets, including goodwill and other intangible assets; accounting for financial assets (fair value); going concern; and use of non-GAAP metrics. With companies making more tough calls, regulators are emphasizing the importance of well-reasoned judgments and transparency, including contemporaneous documentation to demonstrate that the company applied a rigorous process. Given the fluid nature of the long-term environment, disclosure of changes in judgments, estimates, and controls may be required more frequently.

— *Internal control over financial reporting and probing control deficiencies.* Internal controls will continue to be put to the test in the coming year. When control deficiencies are identified, it's important to probe beyond management's explanation for "why it's not a material weakness" and help provide a balanced evaluation of the deficiency's severity and cause. Is the audit committee—with management—regularly taking a fresh look at the company's control environment? Have controls kept pace with the company's operations, business model, and changing risk profile, including cybersecurity risks? Does management talk the talk and walk the walk?

## Monitor the SEC's rulemaking activities on climate and other ESG disclosures and clarify the audit committee's related oversight responsibilities.

Companies are facing increasing demands—from investors, research and ratings firms, activists, employees, customers, and others—for more transparent and higher quality information about corporate sustainability efforts. How is the company addressing climate and other ESG risks and issues—from DEI efforts to the company's "purpose" and how it's considering the interests of stakeholders, including employees, suppliers, and the communities in which it operates?

Climate and other ESG disclosures are clearly a priority for the SEC: In March 2021, the Commission announced the creation of the Climate and ESG Task Force in the Division of Enforcement, focused on identifying any material gaps or misstatements in companies' disclosure of climate risks under existing disclosure requirements. The SEC also issued a request for public comment from investors and other market participants "[i]n light of demand for climate change information and questions about whether current disclosures adequately inform investors." And in September, the SEC provided a sample letter to companies offering takeaways for them to consider as they prepare their climate disclosures. The sample builds on the Commission's 2010 guidance that called for disclosure regarding the physical impact of climate change on companies' businesses, such as threats to hard assets; how environmental legislation and regulation could affect operations and strategies; and potential indirect consequences from regulation or ecofriendly trends. The SEC is expected to propose disclosure rules on climate change, HCM (including diversity), and cybersecurity risk governance in early 2022. Monitoring the SEC's rulemaking activities in these areas should be an audit committee priority, together with a focus on how management is preparing to address these new mandates.

In this environment, we can expect increasing stakeholder demands for more detailed climate/ESG reporting. Audit committees should encourage management 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 various ESG raters—particularly those used by a company's investors, understanding the expectations of investors and other stakeholders, and considering the appropriateness of ESG reporting framework(s) for the company.

But it's important to note that the company's efforts should be about more than just ESG ratings. It is also about how climate and other ESG risks and opportunities are managed and their impacts on the creation of long-term value. Investors want to understand which climate and other ESG risks pose a threat to the company's strategy, operations, and financial condition, and are of strategic significance to the company. How is the company addressing climate and ESG as long-term strategic issues and embedding them into the company's core business activities (risk management, strategy, operations, 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?"

Oversight of a company's climate, ESG, and DEI activities is a formidable undertaking for any board and its committees. Audit committees typically have responsibility for oversight of the company's related disclosures, including the selection of a disclosure framework(s), consideration of where the disclosures should be made, management's disclosure controls and procedures, and any third-party assurance. The audit committee can also play an important catalyst role by helping to ensure that board and committee oversight responsibilities are clear and that communication and coordination among the board and its committees are effective. It is quickly becoming clear that ESG issues touch multiple board committees, and oversight responsibilities should be allocated accordingly.

### Stay apprised of global tax developments and risks, and recognize that tax has become an important element of ESG.

Disruption and uncertainty describe the global tax environment today for corporations—particularly multinationals. On the domestic front, the Biden administration is proposing major tax changes that, among other things, would impose a minimum tax on the book income of large corporations, and increase the taxes on income earned outside the U.S. And globally, the OECD is leading efforts to achieve consensus among 140 countries, including the U.S., for global tax reforms to expand jurisdictions' right to tax sales and services to consumers in their markets. The OECD is also leading efforts among countries to establish a global minimum tax. In October, leaders of the G20 endorsed the OECD's reform efforts, including a global minimum corporate tax of 15%, with a view to have the rules in force in 2023. Many details remain to be agreed on regarding the design of these rules, and uncertainty remains as to whether the political commitments achieved at the OECD can be converted to legally binding commitments through adoption into domestic law. In addition to the potential for large-scale global tax reforms, the focus on tax policy as a driver of ESG objectives and tax contribution as a measure of sustainability continues to grow. Many companies are considering governance relating to tax practices, assessing approaches to tax transparency, and considering available incentives in furtherance of ESG goals.

Tax has also emerged as an important element of ESG, with stakeholders expecting companies to conduct their tax affairs in a sustainable manner, measured in terms of good tax governance and paying a "fair share." Many stakeholders view the public disclosure of a company's approach to tax, the amount of taxes paid, and where those taxes are paid as important elements of sustainable tax practice.

In this environment, it is important for audit committees to engage with management in at least three areas:

- Understand the risks posed by the uncertainty and complexity of this evolving tax landscape, as it is likely to have a significant effect on the company in the coming years.
- Help articulate the company's tolerance for reputational risk associated with tax choices that are being made, and evaluate the extent to which the corporate governance framework and associated controls are in place to minimize this risk and or improve sustainability scores.
- Help determine the right approach to tax transparency, as there is no consensus as to what level of reporting constitutes "good tax transparency." Management teams will need to consider stakeholder expectations, relevant standards, regulators, and the tax transparency disclosures of their peers.

### Help sharpen the company's focus on ethics and compliance.

The reputational costs of an ethics or compliance failure are higher than ever, particularly given the increased fraud risk due to employee financial hardship, pressures on management to meet financial targets, and increased vulnerability to cyberattacks. Fundamental to an effective compliance program is the right tone at the top and culture throughout the organization, including its commitment to its stated values, ethics, and legal/regulatory compliance. This is particularly true in a complex business environment, as companies move quickly to innovate and capitalize on opportunities in new markets, leverage new technologies and data, and engage with more vendors and third parties across complex supply chains.

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 ongoing pressures on employees (both in the office and at home), employee health and safety, productivity, engagement, and morale, and normalizing work-from-home arrangements? As we've learned from the events of 2020–2021, leadership and communications are key, and understanding, transparency, and empathy 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 remain 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, obtain information on how such complaints

are resolved and receive information that enables the committee to understand trends? 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.

### Reinforce audit quality and set clear expectations for the external auditor.

Audit quality is enhanced by a fully engaged audit committee that sets the tone and clear expectations for the external auditor and monitors auditor performance rigorously through frequent, quality communications and a robust performance assessment. (See the Center for Audit Quality's External Auditor Assessment Tool). As companies transition back to the office, and as various aspects of the audit may be conducted remotely, setting clear expectations and frequent quality communications with the external auditor is vital.

In setting expectations of the external auditor for 2022, consider the lessons learned from 2021—the first audit while working remotely. Audit committees will want to discuss with the auditor what aspects of the 2022 audit will be conducted remotely, and what aspects of the audit will be done differently in 2022. What worked well in 2021, and what are the opportunities for improved efficiency in 2022? What complexity does working remotely add to the audit? How have the company's financial reporting and related internal control risks changed? What are the auditor's plans to keep the 2022 audit and the 2022 interim reviews on track?

Set clear expectations for frequent, open, candid communications between the auditor and the audit committee—beyond what's required. The list of required communications is extensive and includes matters about the auditor's independence, as well as matters related to the planning and results of the audit. Taking the conversation beyond what's required can enhance the audit committee's oversight, particularly regarding the company's culture, tone at the top, and the quality of talent in the finance organization.

Audit committees should also probe the audit firm on its quality control systems that are intended to drive continuous improvement in audit quality—including the firm's implementation and use of new technologies. In discussions with the external auditor regarding the firm's internal quality control system, consider the results of PCAOB inspections and internal inspections and efforts to address deficiencies. Remember that audit quality is a team effort, requiring the commitment and engagement of everyone involved in the process—the auditor, audit committee, and management.

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

The acceleration of digital strategies and transformations that many companies are undertaking are impacting finance organizations and presenting 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? What risks are associated with such technology and how are they being addressed and mitigated?
- 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 of new transaction-related technologies, from blockchain to cryptocurrencies. As historical analysis becomes fully automated, the organization's analytics capabilities should evolve to include predictive analytics, an important opportunity to add real value.
- 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? This remains challenging in the current labor-constrained environment. In this environment, it is essential that the audit committee devote adequate time to understand finance's transformation strategy.

### Help ensure that internal audit is focused on the company's critical risks.

Is the internal audit plan risk-based and flexible—and does it adjust to changing business and risk conditions? This is an increasingly common question that audit committees are (or should be) asking the chief audit executive. While a global pandemic was perhaps not on internal audit's list of likely risk events heading into 2020, audit committee members we recently surveyed said, by and large, that their internal auditor pivoted effectively—to reviewing management's updated risk assessments as well as management's remediation plans and controls for those risks.

Going forward, the audit committee should work with the chief audit executive and chief risk officer to help identify the critical risks—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—that pose the greatest threat to the company's reputation, strategy, and operations, and to help ensure that internal audit is focused on these key risks and related controls. Ask again whether the audit plan is risk-based, flexible, and can adjust to changing business and risk conditions. What's changed in the operating environment? What are the risks posed by the company's digital transformation and by the company's extended organization—sourcing, outsourcing, sales, and distribution channels? Is the company sensitive to early warning signs regarding safety, product quality, and compliance? What role should internal audit play 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.

### Make the most of the audit committee's time together.

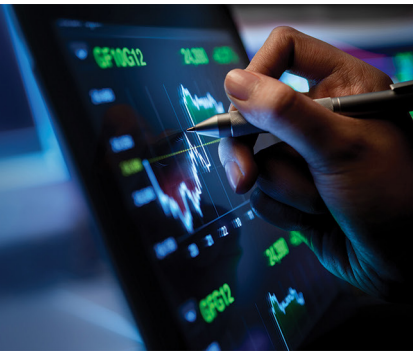
Effectiveness requires efficiency. As we noted at the outset, keeping the audit committee's agenda focused on financial reporting and related internal control risk is essential to the committee's effectiveness; but meeting the workload challenge requires efficiency as well. Streamline committee meetings by insisting on quality pre-meeting materials (and expect pre-read materials to have been read), making use of consent agendas, and reaching a level of comfort with management and auditors so that financial reporting and compliance activities can be "process routine" (freeing up time for more substantive issues facing the business). Other key questions to pose periodically:

- Does the audit committee leverage the array of resources and perspectives necessary to support the committee's work?
- Does the committee spread the workload by allocating oversight duties to each audit committee member, rather than relying on the audit committee chair to shoulder most of the work? Does the committee have the expertise to oversee all of the issues delegated to it?
- Is sufficient time spent with management and the auditors outside of the boardroom—to get a fuller picture of the issues?

Also take a hard, honest look at the committee's composition, independence, and leadership. Is there a need for a fresh set of eyes, or deeper (or different) skill sets? ■

# Financial reporting and auditing update

**Current quarter financial reporting matters**



## 2021 AICPA and CIMA Conference highlights

In December, the AICPA and CIMA hosted the annual Conference on Current SEC and PCAOB Developments. The tone of the conference was set by the first speaker, Tracey Golden, former chair of the AICPA. Golden talked about the environment in which the profession is operating, which provided context to the many emerging issues addressed during the conference. "If you attended last year's conference, you would have heard me talk about the rapid change happening within our profession—how we need to adapt, embrace technology, and evolve our skills to the challenges of the future," Golden said. "Well, that future is here. We're living through those challenges. Constant and accelerated change has become our normal …"

During his keynote remarks, SEC Acting Chief Accountant Paul Munter outlined three elements necessary to support high-quality financial reporting: high-quality standard-setting, high-quality implementation and application of those standards, and high-quality audits. Key themes from the conference spanned across all three elements, serving as important reminders for preparers and auditors as they approach the 2021 calendar year–end financial reporting season.

Highlights of the conference include:

### ESG: Get ready for action

ESG reporting is among the hottest topics in the accounting profession today. Although many companies may have prepared sustainability reports for a few years, momentum has never been stronger for ESG disclosure standards and related assurance. Underlying this momentum is the evolving need of the investor community for more consistent, comparable, and reliable ESG information from companies to inform capital allocation decisions. Both the SEC and the newly formed International Sustainability Standards Board are developing rules concerning ESG matters.

### SPACs: New trend in capital formation

Capital formation has not been slowed by the disruptions caused by COVID-19. It remained robust in 2020 and accelerated in 2021, with the SEC staff reviewing a high volume of traditional IPOs and SPAC IPOs. During this time, SPAC IPOs have outnumbered traditional IPOs. Understandably, considerable time was devoted during the conference to regulatory, accounting, and other issues related to SPAC and de-SPAC transactions.

### Materiality and restatements

Historical financial statements that are accurate and reliable remain the bedrock of financial reporting and investor protection. SEC staff from the Office of the Chief Accountant (OCA), the Division of Corporation Finance, and the Division of Enforcement all emphasized the importance of thoughtfully evaluating the materiality of errors identified subsequent to the issuance of the financial statements. The OCA observed that "little r" restatements increased from 35% of all restatements in 2005 to 76% in 2020. A restatement is a "little r" when errors are corrected in current-period comparative financial statements without reissuing the prior-period financial statements. This trend is of interest to the SEC and there was significant discussion throughout the conference on this topic.

### SEC: Other areas of focus

The SEC staff also discussed developments under the Holding Foreign Companies Accountable Act, spring-loaded share-based compensation awards, reference rate reform, COVID-19-related disclosures, non-GAAP reporting, segment reporting, and cybersecurity risks.

### Accounting: Looking back and looking forward

The most notable topics discussed include accounting for digital assets, revenue recognition, and current expected credit losses standard developments.

### Auditing: Independence at its core with an eye toward technology

Auditor independence was discussed during several panels, illustrating how foundational auditor independence is to the integrity of the financial reporting process. Other topics addressed include the increased use of data and technology in audits and the SEC staff's recent observations on auditor independence, particularly when companies are planning an IPO. ■

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*For more detail about these and other financial reporting and auditing issues, see* 2021 AICPA Conference on Current SEC & PCAOB Developments *and the KPMG* Q4 2021 Quarterly Outlook.

# African American representation on Fortune 1000 boards

A wide range of corporate stakeholders, including business leaders, institutional investors, customers, and global stock exchanges, have publicly acknowledged the underrepresentation of African Americans in the boardroom and the need for diverse voices in corporate leadership. Despite the progress made since the murder of George Floyd in the spring of 2020, there is still much work to be done.

Board diversity has been acknowledged through both the business case and through the lens of equity and social justice. An effective board has directors who not only appear diverse but also bring diverse thoughts, opinions, and experiences to the boardroom discussion. The urgent need to increase the number of African American voices in the boardroom has perhaps never been greater.

In light of the lack of consistent disclosure of data on board racial and ethnic diversity, the KPMG BLC, in collaboration with the African American Directors Forum, analyzed the representation of African American directors on public Fortune 1000 boards. The report, *African American representation on Fortune 1000 boards*, shows that although African Americans comprise 12 percent of the U.S. population, only 8 percent of board seats of public Fortune 1000 companies were held by African Americans as of December 31, 2020.[1]

The following are select findings from the report:

— **Nearly 40 percent of public Fortune 1000 companies did not have an African American director serving on the board.** While a majority (61%) of the public Fortune 1000 companies had at least one African American board member by the end of 2020, only 21% had more than one. In comparison, 49% of Fortune 100 boards had more than one African American director.

— **The vast majority of African American directors who joined public Fortune 1000 boards in 2020 did so during the second half of the year.** In 2020, 180 board seats held by African Americans were added to public Fortune 1000 boards, twice the number added in 2019 (88 seats). Nearly three-quarters (72%) of the seats added in 2020 were added in the second half of the year, following the murder of George Floyd and the subsequent focus on addressing racial inequity in corporate leadership.

— **African American directors of public Fortune 1000 companies are more likely to be female and younger than all public Fortune 1000 directors.** Among all public Fortune 1000 directors, 26% are female, compared to 38% of the African American directors, and 35% of public Fortune 1000 directors are under age 60, compared to 42% of the African American directors.

— **A majority of the public Fortune 1000 board seats held by African American directors are held by those who serve on at least one committee.** It is most common for African American directors to serve on two committees (47%), while only 16% do not serve on any committee. Out of those African American directors serving on committees, a majority (55%) serve on the nominating/governance committee and nearly half (48%) serve on the audit committee.

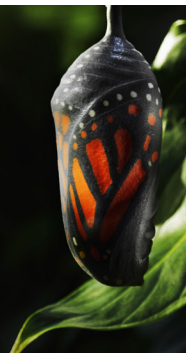
— **The financials; business services; and food, beverages, and tobacco industries have the highest African American board representation among public Fortune 1000 companies.** All are among the top three industries when comparing the percentage of directors in each industry who are African American, as well as the percentage of companies in each industry with at least one African American director. ■

*To read the full report, visit* kpmg.com/us/blc.

[1] The 2020 U.S. Census finds that 12.4 percent of the U.S. population identifies as "Black or African American alone" and 14.2 percent identifies as "Black or African American in combination with another race group." See Nicholas Jones, Rachel Marks, Roberto Ramirez, and Merary Ríos-Vargas, "2020 Census Illuminates Racial and Ethnic Composition of the Country," United States Census Bureau, August 12, 2021.

# Poised for change

## 2021 boardroom diversity survey



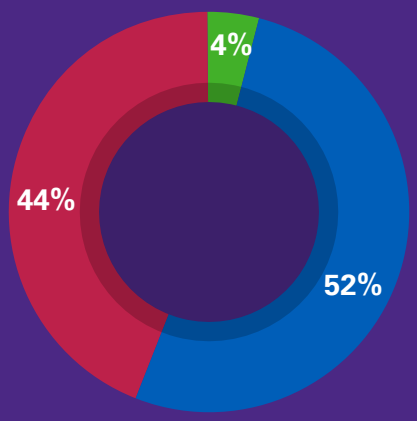
Recent progress—and the continued push—toward greater boardroom diversity comes at a pivotal time for corporate America. The ability to challenge long-held assumptions; understand megatrends; and effectively calibrate strategy, risk, and talent in the context of heightened stakeholder expectations puts a premium on thinking differently.

To better understand how directors view the opportunities and challenges of enhancing diversity in the boardroom, the KPMG BLC surveyed more than 700 directors around the world.

Among the key takeaways:

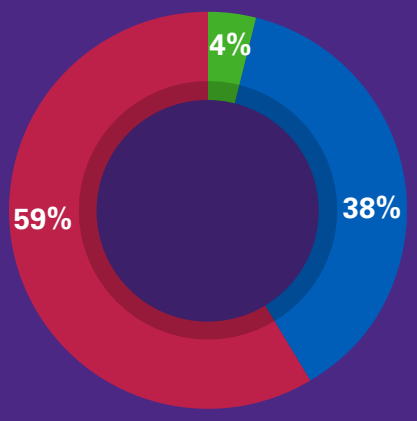
- Many boards are poised for change, and a majority of directors would make changes to their board's composition if starting from a clean sheet today.
- Directors have significant concerns about blind spots and missed opportunities due to a lack of diverse views.
- Racial and ethnic diversity and technology and digital experience are in high demand.
- Achieving better boardroom discussions is a work in progress. ■

**If you were to rebuild your board to best meet your company's needs for today and the future, how different would the board's composition be—including diversity of skills and backgrounds—from its current makeup?**




- Completely different
- Moderately different
- Not meaningfully different

**How concerned are you that a lack of diverse views in your boardroom hampers insightful discussions or identification of blind spots and issues important to the company's future?**




- Extremely concerned
- Moderately concerned
- Not concerned

Does not total 100% due to rounding.

*The complete survey results will be available at* kpmg.com/us/blc.

# Mark your calendar

**BLC Quarterly Webcast**

*January 27, 11 a.m.–12 p.m. (EST)*

Join us for a roundtable conversation with the KPMG BLC team of senior advisors on the challenges and priorities shaping boardroom agendas in 2022.

To register, visit watch.kpmg.us/BLCwebcast.

**NACD Master Class, Laguna Beach, CA**

*March 8–9*

Join experienced lead directors and board and committee chairs for peer-to-peer discussion, networking, and analyses of rapidly emerging disruptions affecting business strategy and long-term value creation.

To register, visit www.NACDonline.org.

## Selected reading

**2021 U.S. Spencer Stuart Board Index**
*Spencer Stuart*

**Net-zero commitments: Where's the plan?**
*KPMG International*

**2021 audit committee transparency barometer**
*Center for Audit Quality*

**An overview of proposed cybersecurity legislation** *Debevoise & Plimpton LLP*

**Board disclosure of race and ethnicity gains traction** *KPMG BLC*

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

**About the KPMG Board Leadership Center**

The KPMG Board Leadership Center (BLC) champions outstanding corporate governance to drive long-term value and enhance stakeholder confidence. Through an array of insights, perspectives, and programs, the BLC—which includes the KPMG Audit Committee Institute and close collaboration with other leading director organizations—promotes continuous education and improvement of public and private company governance. BLC engages with directors and business leaders on the critical issues driving board agendas—from strategy, risk, talent, and ESG to data governance, audit quality, proxy trends, and more. Learn more at kpmg.com/us/blc.

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