Challenging assumptions—or resting on results?

As business cycles go, it doesn’t get much better than this. Consumer confidence is strong and CEOs are bullish, stock markets are hitting all-time highs and unemployment record lows, and signals that the Fed plans to continue rate hikes all suggest solid growth ahead. Yet, tangible concerns, particularly about the long term, should be prompting caution (stubbornly flat wages, mounting trade tensions, resurging debt, impact of the mid-term elections, a looming market correction), and a less tangible but very real risk is complacency—resting on results. Now is precisely the time for companies to be asking the tough, big picture questions about what’s happening in the world and the implications for the company’s strategic assumptions. Are boardroom conversations sufficiently wide-ranging, inclusive (of diverse internal and external views), and forward-looking? Is the board helping the company think hard about the future?

This quarter, we look at current trends in board leadership, two emerging areas of focus for lead directors, how young and growing companies may benefit from using a matrix for board building, and considerations for boards and management in establishing the right control environment for engagement with new technologies such as blockchain. We also highlight financial reporting and auditing developments that should be top of mind for audit committees.

These and other boardroom priorities will be front-and-center at the 2019 KPMG Board Leadership Conference, January 7–9 at The Ritz-Carlton Orlando, Grande Lakes. Wharton Professor Adam Grant, Vanguard Chairman Bill McNabb, BNSF Railroad Executive Chairman Matt Rose, Admiral James Stavridis (retired), and former U.S. Chief Technology Officer Megan Smith are headlining the program, and we’ll take deep dives with breakouts and committee-focused peer exchanges—all focused on raising the board’s game in 2019.

Enjoy Directors Quarterly and we hope to see you in Orlando.

Dennis T. Whalen
Leader
KPMG Board Leadership Center
We cordially invite you to join us for the 2019 KPMG Board Leadership Conference, January 7–9, 2019 at The Ritz-Carlton Orlando, Grande Lakes in Orlando, Florida.

This conference brings together board directors—along with governance professionals, business leaders, and other luminaries—for a candid dialogue on the challenges and priorities shaping board agendas in the year ahead.

Through a combination of peer exchanges, panel discussions, and breakouts, we will explore a host of timely issues, from the role of the corporation in society, to cyber security, board room diversity, and hot topics on the board agenda. Keynote speakers will share their unique perspectives on the Trump administration, geopolitical hotspots around the world, business trends and the 2019 global economic outlook.

**Featured speakers**

Adam Grant  
Professor, Wharton School, University of Pennsylvania  
Author, *Option B*, *The Originals*, *Give and Take*

Constance Hunter  
Chief Economist, KPMG LLP (US)

Bill McNabb  
Chairman, Vanguard

Matt Rose  
Executive Chairman, BNSF Railway

Megan Smith  
CEO, shift7  
Former U.S. Chief Technology Officer

Admiral James Stavridis (retired)  
Former NATO Allied Supreme Commander  
Dean – Fletcher School of Law and Diplomacy, Tufts University

Cindy Fornelli  
Executive Director, Center for Audit Quality

Register now at kpmg.com/us/boardleadershipconference
How lead directors are helping their boards keep pace

The demands on the board’s time and agenda continue to mount as a host of critical issues—from technology and business model disruption to investor scrutiny, and from regulatory and political uncertainty to geopolitical risk—collide and reshape the business landscape. As the business and risk environment becomes more complex, how are lead directors helping their boards add value and raise their game? What are their key areas of focus?

Discussing these questions with a number of lead directors, I’ve heard several recurring themes: the importance of the lead director’s role in setting the board agenda, the lead director’s relationship with the CEO, CEO/leadership succession, and shareholder communications. But virtually all the lead directors emphasized the importance of two additional topics that need to be top-of-mind: board composition and diversity, and enhancing board operations and oversight processes.

Board composition and diversity continues to be a key area of focus for institutional investors, who express concern about low director turnover and whether boards are comprised of directors who can guide the company and its strategy in the future. As Vanguard chair and CEO William McNabb wrote in a 2017 letter to public company directors, the board “is one of a company’s most critical strategic assets,” and it looks for “a high functioning, well-composed, independent, diverse, and experienced board with effective ongoing evaluation practices.”

Developing and maintaining a high-performing board requires leadership and close coordination between the lead director and the nominating governance committee chair—whose responsibilities for board composition may be similar or perhaps overlap. While determining the company’s current and future needs is the starting point for board composition, a broad range of related issues require leadership and coordination—including succession planning, director recruitment, age and term limits, diversity, board and individual director evaluations, removal of underperforming directors, board refreshment, as well as disclosures regarding these issues. As one governance observer has noted, the quality of board governance begins with the composition of the board.

Also top of mind for lead directors today is enhancing board operations and oversight processes, including coordination across committees to bring the right focus and attention to those issues that are most critical to the company’s success and long-term value creation, such as strategy, innovation, disruption and strategic risks, capital allocation, performance, leadership and talent. To devote more time to these issues, while also remaining focused on compliance, operations, and so-called rear-view mirror items, many boards have significantly increased their time commitment in recent years. But that alone is not sufficient, and lead directors and nominating governance committee chairs are now focused on how they can improve board operations and oversight processes—and the nature of their engagement with management teams and among directors—to devote more time to these critical issues. Among the steps lead directors are taking:

— Crafting board agendas to devote more time to key issues
— Assigning board committees to take deeper dives into issues that require more focus and attention
— Improving communications between the board and its committees
— Considering the quality of information flow and boardroom discussions
— Reassessing committee structure, including the need for additional committees (e.g., finance, technology, risk)
— Encouraging greater engagement among directors between board meetings
— Tapping individual directors to take the lead on specific issues
— Developing an effective process to “connect the dots” and help ensure the alignment of talent, compensation, culture, risk appetite, and controls with strategy

In short, the important, and difficult, question lead directors are asking today is whether management and the board have the right governance structure and processes in place to drive critical business activities—to manage risk and calibrate strategy in a coordinated way.

Dennis T. Whalen is Leader of the KPMG Board Leadership Center.

This article originally appeared in the NACD BoardTalk Blog.
Financial reporting & auditing update

The 2019 effective date of the leases standard for public companies is almost here. Companies are focused on understanding the implications of the FASB’s recently issued accounting technical corrections and amendments. Soon, they will need to shift their focus to aspects of adoption beyond the technical accounting, including internal controls over financial reporting and disclosures.

Meanwhile, the FASB’s work on other standard-setting projects to simplify and clarify current accounting guidance continues. These and other accounting and financial reporting developments potentially affecting you in the current period or in the months ahead, are summarized below. (For more detail about these and other issues, see KPMG’s Quarterly Outlook.)

Current quarter financial reporting matters

Reporting under the revenue recognition standard. With calendar year-end public companies now reporting under the new revenue recognition standard, focus has largely shifted from implementation issues to the quality of adoption disclosures and reasonableness of related accounting judgments. The SEC staff has expressed disappointment in the boilerplate nature of disclosures. In particular, staff has said that disclosures do not sufficiently address the significant judgments companies are making about performance obligations, timing of revenue recognition, licensing arrangements, and “gross versus net” presentation. Also, for some companies, implementation of the standard involved a manual approach, combining manual processes with enabling technology and tools. Audit committees will want to help ensure that these manual work-arounds don’t become permanent, and that the work-arounds are automated as soon as possible.

SAB adjustments related to tax reform law. Since the SEC staff issuance of SAB 118, many companies have been recognizing provisional income tax amounts for the effects of the 2017 tax reform law, and continue to adjust balances that were recorded provisionally as of December 31, 2017. Because the SAB 118 measurement period for provisional amounts cannot extend beyond one year—the provisional amounts must be finalized by calendar year-end companies by December 31, 2018.

New standards and guidance

Leases standard effective date draws near. The 2019 effective date for the leases standard is almost here. Companies are currently focused on understanding the implications of the FASB’s recently issued accounting technical corrections and amendments. However, they will soon need to shift their focus to the broader aspects of adoption, including internal control over financial reporting and disclosures. Of course, the SEC staff continues to closely monitor SAB 74 transition disclosures for the leases standard. These disclosures should be a key area of focus for audit committees in connection with their company’s third quarter 10-Q and 2018 10-K.

Implementing the credit impairment standard. The FASB’s credit impairment standard will be effective in 2020 for public companies. Companies should be analyzing the implications of adopting this standard and considering the adequacy of their transition disclosures about the expected effects of adoption. Although the standard is not effective until 2020, those companies that will be most affected by its requirements should be making significant progress toward adoption. The nature and extent of preparations will vary, but companies will need to thoroughly evaluate the effect of the standard and determine what changes will be necessary. Companies may need to collect more data, and significantly change their systems, processes and internal controls to comply with the standard.

Expanding the audit report to include critical audit matters or CAMs. In June 2017, the PCAOB adopted a new auditing standard to make the auditor’s report more informative, by (among other things) expanding the audit opinion to include a discussion of the critical audit matters (CAMs) that arose during the audit. The description of CAMs is intended to provide information about audit areas that were especially challenging, subjective, or required complex judgment, and to explain how the auditors addressed these issues. The CAM requirements will take effect for audits of fiscal years ending on or after June 30, 2019 for large accelerated filers.

It is expected that in most audits, the auditor will identify at least one CAM. However, in the infrequent circumstances that no CAMs are identified, the auditor is required to state that in the auditor’s report. Early engagement between the auditor, management and audit committee will be key to successfully implementing the CAM reporting requirement. Management and the audit committee should begin talking now with their
In a recent Defining Issues®, KPMG partners Brian Fields, lan Wildenborg and others shared their views on the impact of blockchain technologies and accounting for digital assets, including bitcoin and other cryptocoins. While there is much press about how blockchain might impact business processes (including everything from securities settlement to supply chain management), governance and internal controls has received less focus amid the excitement.

Boards and management play key roles in establishing the right control environment for engagement with new technologies. One helpful way to approach those responsibilities is by leveraging an existing framework to provide a structured approach, such as the COSO framework commonly used by companies for financial reporting compliance objectives. Here are some issues that the board and management might consider when engaging with this emerging technology:

— Does the board have an adequate understanding and oversight of the company’s objectives to ensure management is using new technologies in a well-controlled manner?

— Has the audit committee evaluated management’s response to risks identified, including discussing these risks with the external auditor?

— Does the company employ individuals with adequate knowledge and understanding of the technology and identified risks?

— Has the company identified and complied with the relevant accounting and reporting standards associated with the company’s blockchain implementation?

— Have fraud risks been identified and addressed?

— Does participation in blockchain activities create new relationships that may require an assessment of counterparty risks; subject the company to new regulatory requirements; create related party considerations; or impair independence with the external auditor?

— Have controls over development of blockchain systems been designed to verify the systems can accommodate and respond to business needs and risks before they are deployed?

— Have blockchain system deployment policies and procedures been designed to respond to the nature of the blockchain architecture, its consensus and verification mechanisms and the economic incentives of the participants?

— Have policies and procedures related to the safeguarding of digital assets been developed? For example, assets traded on decentralized networks such as bitcoin are often susceptible to theft if security of a private key is compromised.

— Has the company established data and information requirements to verify relevant information from blockchain activities is properly captured, used and retained?

— Is the information obtained from blockchain systems timely, accurate, complete, verifiable and sufficient?

— Are existing IT practices sufficient to address data management and governance for the blockchain systems?

Companies have an obligation to maintain accurate books and records under a system of quality control that provides reasonable assurance that financial reports are complete and free from error. The Defining Issues® outlines a structured approach to identifying relevant risks, determining appropriate control activities and generating relevant, quality information to be used in evaluating compliance objectives associated with blockchain technologies.

Read the Defining Issues at kpmg.com/us/frv.
Matrix thinking, regardless of size or stage

by Susan M. Angele and Ari I. Weinberg

The use of a board composition matrix is a common practice among public companies, and disclosure of the matrix is increasingly expected by institutional investors. Highlighting the qualifications and skills of each director and identifying gaps in skill sets needed to move the company forward, a matrix model can help boards reflect on their overall composition and serve as a foundation for development of a thoughtfully constructed board.

For young and growing companies, particularly those backed by venture capital funds, board building is often more informal and less strategic. Yet a long-term approach to building a strong board as the company grows can make a difference. Whether founder, executive, major investor, or independent, the role of the corporate director as fiduciary does not change. Directors are expected to provide oversight of strategy, risk management, controls and capital allocation, approve executive compensation and incentives, and hire the auditors. A thoughtfully constructed board can bring a mix of skills and perspectives that serves as a competitive advantage.

Of course, venture capital-led boards have their strengths. Executive and director compensation is closely aligned with strategy. There is often industry knowledge in the boardroom, beyond the executive team. Communication with management is constant. The time horizon and relative illiquidity of the investment should drive a focus on value creation.

Yet these boards are not without their challenges. Investment firms dominate the board. Their limited partners have return expectations. Investors may have different liquidation preferences. Related-party transactions are prevalent. And accountability is blurred.

From a corporate governance perspective, these factors may also lead to risk oversight challenges. Governance systems and processes are often immature. Audit committees are more informal. Non-financial controls may not be fully developed, and the corporate culture is still emerging. Lastly, overboarding of investment professionals has become an issue as money rushes into private investments.

Moving toward a matrix: Why it matters

Young companies can use a matrix as an aspirational tool to help target skills to add over a period of time as the company matures and the board grows. Boards should be developed with reference to the question: what does the company need? Might it benefit from a director who can provide strategic insight on sustainability? What about global operating experience or public company board governance?

How is the company currently accessing insight on product development, strategic planning, or rapid scaling? What about oversight of regulatory compliance or guidance of talent strategy? In recruiting for new skills, which should take priority and which can wait?

Consideration of diversity is a critical aspect of board-building and an enabler to improve innovation, insight, and decision-making. According to the 2017-2018 NACD Private Company Governance Survey, only 13% of private-equity (and VC) owned companies adopted formal diversity targets for their boards, yet numerous studies have shown that more diverse boards and leadership groups can bring about higher valuations and greater return on equity.

Constructing a matrix

Earlier this year, we led a group of venture capital investors in an exercise to future cast a board matrix. While some said they had previously worked with a similar framework, most said that their firms did not have specific processes and considerations for board building. Using the example matrices here, we asked them to consider the following:

– **Establish the endgame.** How far is the company from a potential outcome? What is the range of those outcomes? What would a buyer or a public investor expect from the board?

– **Work backward to current state.** What would the company or CEO need from the board to achieve that outcome? When? How would the company source directors or advice?

– **Build the road map.** How are those future board seats and capabilities “filled” today? What skills and insight are being contributed by investment firms or independent directors? What about educational activity and formal/informal networks? Are professional service firms being relied on for support that might otherwise come from a fiduciary board?

While venture firms have different roles in building portfolio company boards, they should at least start a conversation collectively about the process. What have they found works well and what lessons have they learned? How would they benefit from more diverse early-stage boards? And how would a board that matures ahead of the company offer feedback on strategy, help to oversee culture and controls, and guide the company to growth?

Process can be an enabler when you build a board with intention.
Qualifications

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<th>Director 3</th>
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<td>Diversity</td>
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<td>Sustainability</td>
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Skills/expertise

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<td>Scaling/growth hacking</td>
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<td>Technology</td>
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<td>Risk/crisis management</td>
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Susan M. Angele is Senior Advisor and Ari I. Weinberg is Associate Director at the KPMG Board Leadership Center.
The statistics are sobering, and the business impact can be significant. More than 700 executives and senior-level employees have been publicly accused of sexual misconduct since December 2015, according to research by Temin and Company. Indeed, the likelihood of an organization of any significant size having a #MeToo issue is very real. Boards need to redouble their oversight of this issue, and audit committees can help sharpen the focus. We offer these suggestions.

Focus on the effectiveness of reporting channels and investigation processes through a #MeToo lens.

The audit committee should add a #MeToo lens to its role in assisting the board in monitoring compliance by taking a deep dive into how the company’s policies work in practice. Is there a strong process for management to review and update the company’s policies on sexual harassment to ensure that they remain appropriate and relevant? How well are the avenues for raising sexual misconduct complaints communicated throughout the organization? Do employees truly feel comfortable raising concerns? Has internal audit, as the eyes and ears of the audit...
committee, been asked to weigh in through this lens? When complaints are reported, what is the escalation process? Does the audit committee or the board know about a sexual misconduct complaint against an executive as soon as it is reported, or only when it hits the media? And what about complaints deeper into the organization? While the committee may not need to see every individual complaint, working with the chief compliance officer to develop a protocol for reporting on sexual misconduct complaint trends can help the board stay ahead of the issues.

**Monitor for accountability, fairness, transparency and a tone of respect.**

First and foremost, the committee and board should send a strong message that intentional misconduct and predatory sexual behavior will not be tolerated under any circumstances by any individual affiliated with the company, should expect company leadership to send and enforce the same message, and should assess whether training, employment practices, and compensation incentives align with this directive. The audit committee should set and expect a tone of transparency and respect, and assess whether management is providing sufficient clarity in policies and training. In addition, the committee and board should monitor for unintended consequences. Are young professional women losing opportunities for informal mentoring or projects requiring travel due to concerns of male managers that they may be wrongfully accused? Are employees who raise complaints being retaliated against overtly or in subtle yet potentially career-damaging ways? Is management handing complex issues fairly and minimizing the risk of backlash? And is the company positioned to respond quickly and appropriately in the event that an incident becomes public? Given the importance of corporate culture to attracting and retaining the right talent, these issues should be on the board’s radar and monitored either by the audit committee or another appropriate designated committee.

**Include sexual harassment issues in due diligence reviews.**

Given the potential impact of #MeToo issues, companies are digging deeper into the backgrounds of aspiring executives and board members, a practice referred to as “social due diligence.” In addition, a new provision has begun to appear in acquisition agreements—the “#MeToo rep.” In this provision, the seller represents that with respect to a certain subset of executives/senior managers/board members, no allegations of sexual harassment have been made within an agreed-upon number of years (currently ranging from 3 to 10). As these practices become more commonplace, audit committees and boards should have them on their radar as they consider succession planning, acquisitions, and divestitures.

#MeToo issues present potentially significant risks, and the audit committee can play a critical role in setting the right tone and monitoring compliance.

*A version of this article originally appeared in The Power of Difference, a supplement to the September/October 2018 issue of NACD Directorship magazine.*
Companies and investors continue to grapple with what constitutes the optimal leadership structure for boards. During the 2018 proxy season, shareholder proposals requesting separation of the CEO and chair roles (or an independent board chair) were once again among the most common governance proposals. Consistent with prior years, the proposals fared well, averaging 32 percent support, but none passed.¹ These results highlight that investors have mixed views on board leadership. They also demonstrate that having a lead director—an independent director who serves as the representative of the independent directors and as a counterweight to a combined chair/CEO—can satisfy investors seeking independent board leadership if the lead director has robust and well-defined responsibilities.

Prior to the scandals that gave rise to the Sarbanes-Oxley and Dodd-Frank Acts, one individual typically served as both CEO and chair at U.S. public companies. Yet, combined roles raise complicated conflict of interest issues on matters such as executive compensation and CEO succession, since the primary role of the board is overseeing management. At the same time, it is not clear that splitting the roles leads to better performance or governance quality,² and splitting presents the potential for the CEO and chair to duplicate efforts or work at cross purposes while sowing internal confusion. Thus, each board should review its leadership structure in light of current circumstances and then disclose

¹ Governance Debates by Claudia H. Allen
in its proxy statement the rationale for combining or splitting the roles. If the roles are not split, a company must disclose whether it has a lead director—and the role played by the lead director.3

Notably, the decision to combine or split the roles is often situational, and the board may change its views in response to changing circumstances. For example, the board may split the roles in response to a crisis or when hiring a new CEO, and may combine the roles after a new CEO has proven him or herself and made the case for having both roles. Many companies have corporate governance guidelines that are flexible on the issue, stating that the board has not adopted a formal policy on splitting or combining the roles.

While splitting the roles has become more common, having different individuals serve as CEO and chair does not automatically mean having an independent chair. For example, when a company appoints a new CEO, the outgoing CEO may serve as nonexecutive chair for an interim period to facilitate the transition. According to the 2017 Spencer Stuart U.S. Board Index, 51 percent of the companies in the S&P 500 split the roles—marking the first time that a majority of the constituents did so—but only 28 percent had an independent chair. In 2007, the comparable percentages were 35 percent and 13 percent. An analysis of S&P 1500 companies by proxy advisor Institutional Shareholder Services (ISS) found that small- and mid-cap companies split the roles more frequently than their large-cap counterparts.4

In 2017 89 percent of S&P 1500 companies had some form of independent board leadership, up from 67 percent in 2008. Breaking these numbers down, 35 percent had an independent chair in 2017 compared to 20 percent in 2008, while 54 percent had a lead director in 2017, compared to 47 percent in 2008. Thus, the overall trends favor more independent leadership, but most frequently in the form of a lead director.

While the independent chair and lead director roles are both typically held by seasoned independent directors with stature, there are differences between the two. Unlike the lead director, the chair typically has the power under the company’s organizational documents to call a meeting of the board and preside at board and shareholder meetings, while also having the practical power to control the agenda and information flow for board meetings. The lead director typically presides at meetings of the independent directors and, as the representative of the independent directors, works with the chair to set the board agenda and determine what information is provided to the board. The role of lead director is evolving, and some companies have added responsibilities such as being available to engage with major shareholders and participating in the board’s self-evaluation.

Institutional investors and proxy advisors continue to rely on the description in a company’s proxy statement and corporate governance guidelines of its lead director role to determine if it satisfies their baseline for independent board leadership. In that regard, in its 2017 Stewardship Report, State Street Global Advisors noted that “the most significant improvement has been companies strengthening the lead independent director role by expressly identifying involvement in strategy as a responsibility of the job description.” Accordingly, boards should continue to review the role played by their lead director and update the role and its description as appropriate.
Mark your calendar

**Council of Institutional Investors Fall 2018 Conference, New York, NY**
**October 23–25**

During the Council of Institutional Investor’s Fall conference, the Board Leadership Center will co-sponsor a panel discussion on addressing portfolio ESG risk through active stewardship.

Members can register at cii.org.

**NACD Master Class, Naples, FL**
**December 6–7**

NACD’s advanced Master Class course will convene highly experienced lead directors, board chairs, and committee chairs for peer-to-peer discussion, CEO fireside chats, interactive simulations, and thought-provoking analysis of emerging issues affecting business strategy and long-term value creation.

Register at www.NACDonline.org.

**KPMG Board Leadership Conference, Orlando, FL**
**January 7–9**

This annual event for board directors, governance professionals, and business leaders explores the governance challenges and priorities driving board agendas in 2019 through a combination of keynote speakers, panel discussions, breakout sessions, and committee-focused peer exchanges. Guest speakers will include Wharton Professor and author Adam Grant and Vanguard Chairman Bill McNabb.

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

**WomenCorporateDirectors ASPAC Institute, Tokyo, Japan**
**February 21–22**

Corporate directors from around the world are invited to join their peers at a pre-Institute networking reception and dinner followed by a full day of programming.

For more information, visit www.womencorporatedirectors.org.

**Selected reading**

- What has (and hasn’t) changed since the financial crisis? McKinsey Global Institute
- Harvey Nash / KPMG CIO Survey 2018 Harvey Nash and KPMG
- How Next Generation Board Directors Are Having an Impact Spencer Stuart
- Reporting non-GAAP financial and operational measures KPMG Global Enterprise Institute
- Critical Audit Matters: Key Concepts and FAQs for Audit Committees, Investors, and Other Users of Financial Statements Center for Audit Quality

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

**About the KPMG Board Leadership Center**

The KPMG Board Leadership Center champions outstanding governance to help drive long-term corporate value and enhance investor confidence. Through an array of programs and perspectives—including KPMG’s Audit Committee Institute, the WomenCorporateDirectors Foundation, and more—the Center engages with directors and business leaders to help articulate their challenges and promote continuous improvement of public- and private-company governance. Drawing on insights from KPMG professionals and governance experts worldwide, the Center delivers practical thought leadership—on risk and strategy, talent and technology, globalization and compliance, financial reporting and audit quality, and more—all through a board lens. Learn more at kpmg.com/us/blc.

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