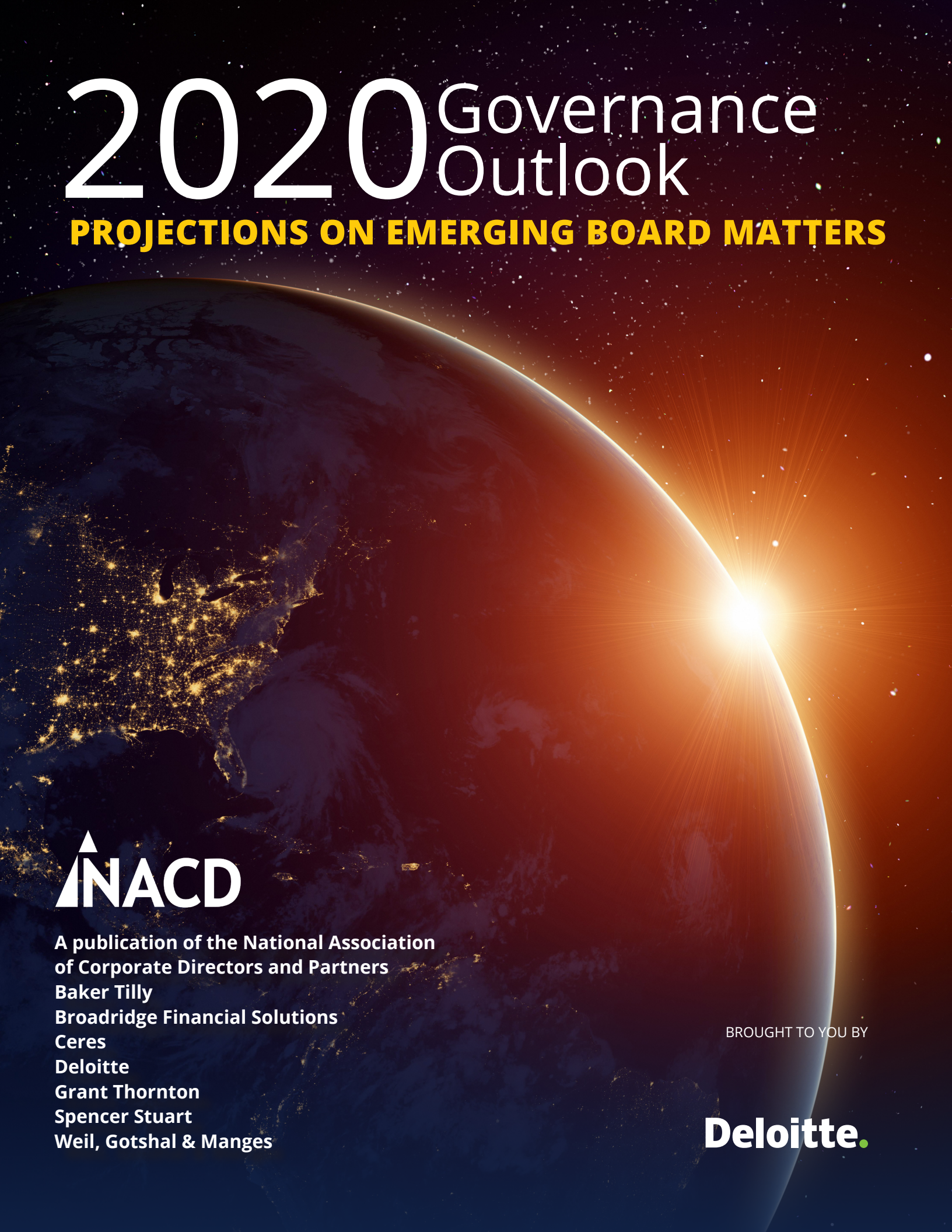
2020 Governance Outlook

PROJECTIONS ON EMERGING BOARD MATTERS



NACD

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ABOUT THIS REPORT

The *2020 Governance Outlook: Projections on Emerging Board Matters* is designed to give corporate directors and senior executives a comprehensive overview of major business and governance issues likely to demand board focus over the coming year. The report begins with an introduction from NACD, highlighting survey findings about leading board priorities for 2020, and follows with eight partner contributions that provide distinct insights and projections on the following themes: preparing for the next recession, strategic business risks, regulatory changes, legal risks, board composition, the digital frontier, ESG and engagement, and water scarcity risk.

Each partner contribution provides (1) an overview of key trends in a particular area of governance, (2) an outlook for how those trends will play out in 2019, and (3) relevant implications and questions for boards to consider. The *2020 Governance Outlook: Projections on Emerging Board Matters* is designed as a collection of observations to help corporate boards prioritize their focus in 2020 and increase their awareness of emerging issues, through both detailed topical analysis and coverage of broader governance implications.

Governing Through Regulatory Change:
A Focus on Financial Reporting, Accounting, Auditing, and Related Governance Matters

By Jennifer Burns, Maureen Bujno, and Andrew Hubacker, Deloitte & Touche LLP

Effective boards remain informed of regulatory priorities (whether directly or with the assistance of their committees) that impact financial reporting, accounting, auditing, and associated governance matters. Keeping these regulatory priorities top of mind is helpful to directors as they engage with management to understand how their companies are monitoring and adjusting to regulatory changes. The US Securities and Exchange Commission (SEC), the Public Company Accounting Oversight Board (PCAOB), and the Financial Accounting Standards Board (FASB) have put forward agendas that they are aiming to take action on in 2020.[1] The SEC, PCAOB, and FASB are operating against the backdrop of broader legislative trends, a looming US presidential election, and potential changes in their leadership, which to varying degrees may impact the activities of each. Below we outline current and expected priorities for each agency, as well as how the board and respective committees should be thinking about the impact on the companies they serve.

SEC Priorities

SEC chair Walter Joseph "Jay" Clayton has emphasized the need to give attention to all three prongs of the agency's mission: "protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation." In 2020, we expect this focus to continue through initiatives related to the following:

Capital Formation and Disclosure Effectiveness

The SEC has several projects related to capital formation and disclosure effectiveness in process, including these:

- The SEC is considering changing the rules that govern which filers qualify as nonaccelerated, thereby expanding the number of filers that qualify as nonaccelerated. In doing so, the SEC is intending to reduce the compliance costs of smaller, less-complex public companies by reducing the number of companies required to obtain auditor attestation on their internal control over financial reporting.
- The SEC is working on the finalization of proposed rules intended to improve the information investors receive regarding acquired or disposed businesses, to reduce the complexity and costs of preparing the required disclosures, and to facilitate timely access to capital, through the following:
  - Significantly simplifying and streamlining the disclosure requirements related to registered debt securities
  - Amending the reporting requirements related to significant acquisitions and dispositions

[1] The SEC's agenda of its rulemaking actions is published twice a year pursuant to the Regulatory Flexibility Act. The FASB technical agenda and the PCAOB standard-setting agenda are updated on a real-time basis.

- The SEC is also working on the finalization of a proposed rule amending the reporting requirements of business disclosures, legal proceedings, and risk factors. Broadly, the amendments would move the reporting requirements toward a principles-based approach. However, the proposed amendments would add the following reporting requirements:
  - **Business disclosures:** Add human-capital disclosures, including any human-capital measures or objectives which are of focus in managing the business, to the extent such disclosures would be material.
  - **Risk factors:** Add a summary of risk factors if the disclosures exceed 15 pages and require the organization of risk factors under relevant headings.

While the timing and specific requirements of any final rule are uncertain, these proposals reflect the SEC's efforts to reassess current disclosure requirements and find opportunities to reduce the burden on registrants while maintaining appropriate investor protection.

Also, although the SEC issued a request for comment on quarterly reports and earnings releases[2] which closed in March 2019, this topic is not currently included in the SEC's near-term agenda. Chair Jay Clayton has stated in public remarks that he does not think the current frequency for interim reporting will change for the largest public companies, but perhaps more flexibility could be afforded for smaller companies. The SEC does remain concerned about short-termism by investors and companies focused on quarterly earnings and held a roundtable on this topic in July 2019.

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Risk Disclosures

The SEC's focus is expected to remain on risk disclosures such as cybersecurity, the transition from LIBOR,[3] and Brexit, as well as the board's risk oversight role on these issues.

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[2] The request asked for feedback regarding the frequency of periodic reporting, the extent of quarterly disclosures, the relationship between required Forms 10-Q and voluntary earnings releases, and the relationship between quarterly reporting and a focus on short-term results.

[3] LIBOR (or the London Interbank Offered Rate) is the basic rate of interest used in lending between banks on the London interbank market and is also used as a reference for setting the interest rate on other loans.

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- **Cybersecurity:** The focus on cybersecurity is expected to continue to be based on
  1. moving from a mind-set that focuses primarily on the prevention of cyberbreaches to a more forward-looking perspective that also takes into consideration whether the companies are collecting data in such a way that the data can be protected,
  2. companies taking steps to ensure they are informing investors about material cybersecurity risks on a timely basis,
  3. the importance of controls related to the identification and escalation of a cybersecurity incident to the appropriate levels within an organization,
  4. the need to address cybersecurity incidents in insider-trading policies, and
  5. the nature of board involvement in the management of cyber risk.

- **Transition from LIBOR:** Banks will likely stop reporting information used to set LIBOR after 2021 and the US Federal Reserve Bank's Alternative Reference Rate Committee has proposed the Secured Overnight Financing Rate (SOFR)[4] as an alternative rate to replace LIBOR. The SEC's focus on disclosures related to the transition from LIBOR is primarily related to companies' disclosures of risk exposure based on contracts indexed to LIBOR that go past 2021.[5]
- **Brexit:** Currently, there is significant uncertainty with respect to the nature and potential effects of Brexit, and the SEC has expressed concern that the effects may be underestimated in public markets. Companies should review their risk disclosures regarding Brexit, and consider whether those disclosures represent an accurate depiction of how management is considering risks related to Brexit and how those risks could affect the company's business.

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[4] SOFR uses data from the overnight Treasury repurchase market to calculate a rate published at approximately 8:00 a.m. New York time on the next business day by the US Federal Reserve Bank of New York.

[5] In July 2019, the staff issued a statement specifically related to matters companies should be actively monitoring and considering related to this topic, and it included matters such as appropriate identification of LIBOR exposure, analysis of existing fallback provisions or the need to engage with counterparties to appropriately identify an alternative rate, and hedging implications among other matters. Companies should review their existing risk disclosures and consider whether they faithfully depict where the company is in the process of assessing the transition from LIBOR and consider disclosing material, qualitative, and quantitative information that would be valuable to investors.

Separately, although disclosure regarding environmental, social, and governance matters is not on the SEC's 2019 Regulatory Flexibility Agenda, it is a topic that is making news headlines.[6] The Energy and Environment Legal Institute submitted a petition for rulemaking on climate disclosures, asking the SEC to clarify its 2010 guidance on environmental risk disclosures. In addition, various members of Congress have proposed more than 50 legislative bills, including H.R. 4329, the ESG Disclosure Simplification Act passed out of the US House of Representatives Financial Services Committee. Should the proposal become law, it would require public companies to disclose certain ESG matters in annual filings with the SEC.[7]

Proxy Voting Responsibilities and Shareholder Proposals

On November 5, 2019, the SEC voted to propose amendments to its rules governing proxy solicitations. These proposed amendments would impact proxy advisory firms, requiring them to (1) disclose material conflicts of interest, (2) give issuers the opportunity to review and comment on advisory firm voting recommendations, and (3) provide a hyperlink to the issuer's response to the advisory firm's voting recommendation. Items (2) and (3) would be available only to issuers who file definitive proxy statements at least 25 days prior to their annual meetings, and the review period would depend upon the length of the period between the definitive filing and the meeting date. The proposal would also amend the definition of "solicitation" and provide for confidentiality of communications between issuers and advisory firms.

Also on November 5, 2019, the SEC proposed rule amendments which would impact shareholder proposals, including (1) changing the holding period (but not the minimum amount of ownership) needed to be eligible to submit proposals, (2) limiting the number of proposals a holder can submit, and (3) increasing the levels of support a proposal must obtain to be resubmitted at subsequent meetings.[8]

Both of the above proposed amendments are subject to a 60-day comment period, and because the proposals cannot be acted upon until at least January, they will not be effective for the peak proxy season in 2020.

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6. See speech by William Hinman, Director SEC Division of Corporation Finance, "Applying a Principles-Based Approach to Disclosing Complex, Uncertain and Evolving Risks," March 15, 2019.

7. For a review of pending congressional bills on this and other governance topics, see *NACD Washington Review Q3 2019*.

8. Under the proposed rule, for example, a proposal would need to achieve support by at least 5 percent of the voting shareholders in its first submission in order to be eligible for resubmission in the following three years. Proposals submitted two and three times in the prior five years would need to achieve 15 percent and 25 percent support, respectively, in order to be eligible for resubmission in the following three years. Congress is also considering H.R.3088, The Shareholder Protection Act of 2019, which addresses this issue.

New Accounting Standard for Estimating Credit Losses (CECL)
Companies and the SEC are focused on the adoption of new accounting requirements under ASC 326 related to current expected credit loss (CECL), which for many public companies will go into effect in 2020.[9] While the requirements will have their greatest impact on banks and other lenders, any business that holds trade receivables, contract assets, loans, debt securities, off-balance-sheet credit exposures, reinsurance receivables, or net investments in leases will need to comply with CECL. The SEC staff has publicly discussed its views on key adoption activities related to CECL, such as the need to focus on internal control considerations and disclosures, including disclosures about how the company will transition to the new requirements. Specifically, the SEC has discussed the importance of companies appropriately assessing their data controls in light of the amount of data required to execute the estimation process in the CECL standard and to adhere to the new disclosure requirements in the standard.

PCAOB Priorities

In 2020, the PCAOB is expected to continue to focus on enhancing its processes—including all programmatic areas.

The PCAOB's current chair and three board members have been in place since early 2018, with another board member joining in November 2019. As a new board they have had the opportunity to take a "fresh look" to enhance the organization and its activities. In 2020, the PCAOB is expected to continue to focus on enhancing its processes—including all programmatic areas (standard setting, registration and inspections, and enforcement). In doing so, the board will likely consider how to further enhance its transparency and outreach with stakeholders; the process, timing, and reporting related to inspections; and its use of advisory groups in relation to standard setting.

In terms of standard setting, the PCAOB has noted that its focus areas will include these:

- Monitoring the auditor's implementation of the reporting of critical audit matters (CAMs)
  - CAMs are required to be included in auditor reports of large accelerated filers for periods ending on or after June 30, 2019, and in auditor reports of all other applicable filers for periods ending on or after December 31, 2020.[10] With the phased effective dates, in 2020 the PCAOB is expected to place significant focus on the first CAMs reported through both inspections and a post-implementation review of the standard, and will consider whether changes to the requirements or guidance are needed to achieve the PCAOB's intended results.

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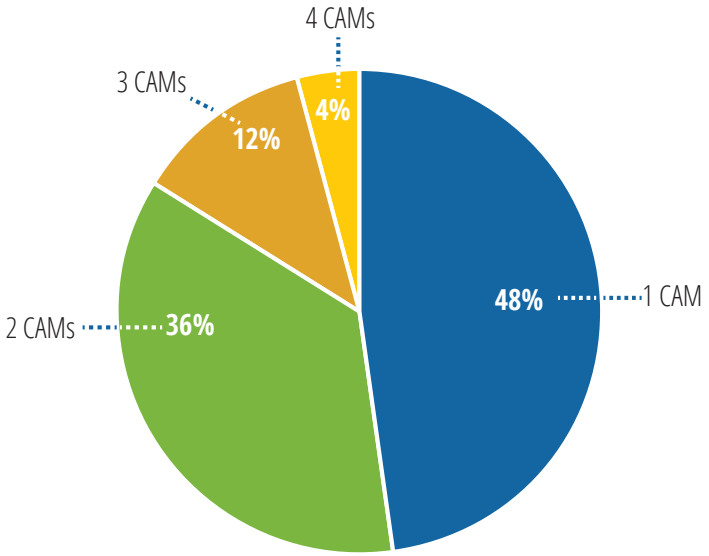
9. For more on CECL, see Deloitte's Insights.
10. In July, the PCAOB released a report on CAMs "to inform audit committees as they engage with their auditors on the new CAM requirements."

Number of CAMs per auditor's report as of November 29, 2019



Information is based on CAMs included in the auditor's reports of large accelerated filers filed as of 11/29/2019.

Based on CAMs included in auditor's reports as of 11/29/2019, the significant majority relate to goodwill and intangible assets, revenue recognition, acquisitions, and income taxes (including uncertain tax positions and deferred income taxes).

- Modifying its quality control standards
  - With a concept release on quality-control standards issued on December 17, 2019, in 2020 there is expected to be significant focus on the responses to the concept release and the direction the standards may take. Changes to the quality-control standards may focus on areas that include firm governance and structure (e.g., firm culture, organizational structure, and leadership roles and responsibilities); quality-control risk assessments and monitoring; continuous improvement; and transparency. By understanding such changes, boards and audit committees can enhance their oversight of the external auditor.
- The use of data and technology in conducting audits
  - Big data and the ever-increasing power of technologies continue to change the landscape of businesses and the performance of audits. This area seems to be one of the PCAOB's key areas of focus on its research agenda, with an active task force providing insights to the PCAOB regarding whether additional guidance or changes to the

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standards are needed to facilitate the use of data and technology in conducting an audit. Based on the attention this topic is getting, we may see some action on this project in 2020.

- Standards related to the auditor's supervision of other auditors (other firms and other individuals) outside the accounting firm that issues the audit report
  - The PCAOB's proposal[11] on this topic is intended to increase the lead auditor's involvement in, and evaluation of, the work of other auditors; enhance the ability of the lead auditor to prevent or detect deficiencies in the work of other auditors; and enhance the quality of the work of other auditors. The PCAOB staff is in the process of determining next steps based on the comments received. Given that the staff previously anticipated action in the third quarter of 2019, we may also see some action on this project in 2020.

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Other projects on the PCAOB's standard-setting and research agenda include going concern, the auditor's responsibility with other information including non-GAAP measures, and the auditor's responsibilities with respect to noncompliance with laws and regulations.

Separately, in Congress, Rep. Sylvia Garcia (D-TX) has proposed H.R. 3625, PCAOB Whistleblower Protection Act of 2019, which would enhance the PCAOB's current enforcement tips and referral program by rewarding individuals reporting violations of securities law "relating to the preparation and issuance of audit reports, auditor independence, and the obligations and liabilities of accountants with respect thereto. . . ."

FASB Priorities

After spending the last decade focusing on major agenda projects, such as revenue recognition and leasing (under the leadership of current chair Russell Golden and his predecessors Leslie Seidman and Robert Herz), the FASB's current agenda includes only a couple of recognition and measurement projects with broader applicability, and several narrower projects focused on improving financial reporting or disclosures in certain targeted areas. Additionally, as always, the FASB spends a significant amount of its time on longer-term conceptual framework and research projects.

[11] In 2016, the PCAOB proposed amendments to its auditing standards to strengthen requirements that apply to auditors that are not part of the accounting firm that issues the audit report (other auditors), and proposed a new auditing standard for situations in which the auditor divides responsibility for the audit with another accounting firm. The PCAOB received comments seeking clarifications to some provisions and changes to others. The staff analyzed comments received and, in September 2017, issued a supplemental request for comment asking for additional feedback.

Chair Golden's second (and last) term expires on June 30, 2020. The new chair of the FASB will be appointed by the Financial Accounting Foundation Board of Trustees who, through their appointments committee, seeks nominations from a wide variety of groups, including financial statement users, preparers, academics, and regulators.

For the remainder of Golden's term, the FASB is expected to focus on these projects:

- Implementation assistance and monitoring of major new accounting standards, including these:
  - Educational and implementation assistance activities for the recently issued, major, new accounting standards, including revenue recognition, lease accounting, accounting for credit losses (mentioned earlier), targeted improvements to hedge accounting, and accounting for long-duration insurance contracts.
  - Implementation and execution of the FASB's post-effective-date review and monitoring program, which seeks immediate feedback on implementation progress and issues for the recently issued, major, new standards, and to inform a longer-term view of each standard's costs and benefits.
- Making continued progress in addressing certain key accounting and reporting issues that stakeholders have asked the FASB to address, including the following:
  - **Accounting for convertible instruments and contracts on an entity's own equity** – This is an area involving significant complexity under current US GAAP, and given this complexity, is a leading source of financial statement restatements. The objective of this project is to improve understandability and reduce complexity, without adversely impacting useful information for users of financial statements.
  - **Reference rate reform** – The FASB is working to identify potential changes to the accounting standards codification to address the potential effects of the market-wide transition from interbank offered rates (such as LIBOR) to replacement reference rates.
  - **Segment reporting** – The FASB is exploring potential improvements to the current segment-reporting guidance, to provide financial statement users with information useful for making decisions.
  - **Disaggregation of performance information** – The objective of this project is to improve the decision usefulness of certain complex line items in an entity's income statement (for example, selling, general, and administrative expense, breaking it out into its components).

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Other projects currently on the FASB's technical agenda include various narrow-scope recognition and measurement projects (e.g., accounting for identifiable intangible assets and subsequent accounting for goodwill, hedge accounting, accounting for share-based payments to customers, consolidation and reorganizations, accounting for asset acquisitions, and accounting for income taxes). In addition, current presentation and disclosure projects are focused on improving disclosures in certain areas for income taxes, inventory, and interim reporting, and simplifying the current guidance related to the presentation and classification of debt on the balance sheet.

Board Implications Related to SEC, PCAOB, and FASB Priorities

The SEC has frequently stressed the importance of board oversight of financial reporting and securities-related matters. Given the above overview of topics, it is likely that 2020 may bring continued regulatory change and possibly more risk to public companies. As such, boards should continue to remain vigilant in their oversight role to make sure that management has adequate policies and mechanisms in place to (1) keep directors informed of these regulatory developments in a sufficient and timely manner, and (2) assess and report on any impact such changes may have on the company.

Financial Expertise on the Board

Given the complexities of the financial arena and the number of regulatory priorities that could impact company strategies, boards are continuing to emphasize the need for having the right financial skills represented. The SEC requires public companies to disclose whether at least one "audit committee financial expert" serves on the audit committee, and if so, the name of the expert and whether he or she is independent of management.[1] There continues to be a high demand for financial experts. According to the 2019 US Spencer Board Index, of the 432 new independent directors, "27% have financial backgrounds, with boards less interested in accounting and banking backgrounds and more focused on candidates with experience as CFOs/finance executives or investment professionals." This is up from 25.5% of the new independent directors in 2018, and up from 18% in 2008, according to the 2018 US Spencer Stuart Board Index.

[1] SEC 17 CFR PARTS 228, 229 and 249 [RELEASE NOS. 33-8177; 34-47235; File No. S7-40-02] RIN 3235-AI66, Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002.

The SEC has also emphasized the important role of the audit committee in promoting an environment for management's successful implementation of new accounting standards. It has specifically noted that audit committees should play a role in overseeing companies' implementation, to help make sure that issues are identified and resolved in a timely manner.[12]

The audit committee is often delegated the responsibility for reviewing and continually monitoring any compliance and regulatory matters that could have a significant impact on the company's financial statements. While many of the above potential regulatory changes and developments may fall under the charter of the audit committee, coordination between board committees is critical, as there may be certain regulatory changes that could be delegated to other committees. For example, changes regarding proxy advisors or other broader shareholder proposal process updates may be brought to the nominating/governance committee by the corporate secretary or general counsel's office, or potential new or enhanced risk disclosures may be a full-board discussion.

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[12] See speech by former SEC chief accountant Wes Bricker in September 2018, in which he stated, "The audit committee plays a vital role in overseeing a company's financial reporting, including the implementation of new accounting standards."

QUESTIONS FOR DIRECTORS TO ASK

Management may find it helpful to inventory all compliance and regulatory updates or potential changes and, working with the board, to define which committee or if the full board will be primarily responsible for oversight of such topics. To the extent changes impact the financial statements or disclosures, the audit committee should coordinate with the other committees or take primary responsibility.

General:

- Is management providing an update to the board (or specific committees) about monitoring potential leadership and agenda changes at the SEC, PCAOB, and FASB and how those changes may impact the respective agendas and priorities?
- Does the board have sufficient transparency into the company's assessment of the impact of proposed regulatory and standard changes and implementation efforts and the challenges related to new reporting requirements?
- Does the board advise management about the topics on which the company intends to engage in the public-comment process when proposed regulatory rules are issued?
- Is the company currently taking advantage of existing or new reporting accommodations in the capital-raising process?
- Has management considered the potential risks of using these accommodations, including potential shareholder or other market reaction?

FASB / PCAOB Specific:

- Does management provide regular updates about relevant standards in the process of being implemented and their related impacts?
- Does the company have sufficient resources and systems to implement new accounting standards and related internal controls?
- Has the external auditor discussed any key changes in auditing standards, including the implementation of CAMs, with management and the audit committee?

Disclosures:

- Has management informed the board about potential changes in disclosure requirements applicable to their company and discussed how they intend to implement changes in a way that benefits both the company and its shareholders?
- Do the board use disclosure developments as an opportunity to discuss with management whether they have considered if the company's disclosure could be enhanced, even absent any rule changes?
- Has management provided the board with any benchmarking of disclosures for the board to understand how their governance disclosure in the proxy and the risk factors in the 10-K compare to peers? Is there any opportunity to refresh any disclosures?
- Does the company's cybersecurity planning include consideration of timely disclosure of cybersecurity-related issues?
- How far along is the company in assessing its exposure to risk arising from the transition away from LIBOR, and do its related disclosures reflect that assessment?
- Does the company have an appropriate understanding of what impact Brexit will have on the company, and do its disclosures appropriately reflect that expected impact?


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