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Adapting Business Strategy to the Regulatory Outlook

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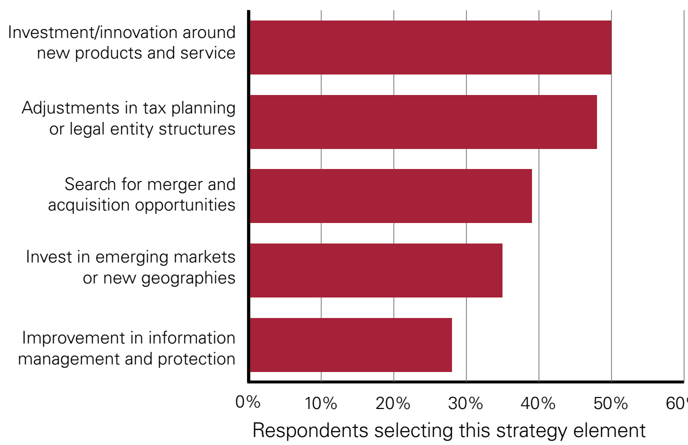
A recent KPMG survey shows how business leaders are applying a new regulatory lens to strategic planning and traditional organizational structures in anticipation of the road ahead.

Over the past year, a series of KPMG surveys indicated that executives around the world were very concerned about evolving legislation and regulation[1] and were focused on recalibrating traditional compliance processes[2]. A new survey indicates companies are now adapting to the long-term legislative outlook and its impact on growth, innovation and other strategies. With this survey, KPMG continues its ongoing review of how public policy is affecting business practices. It reveals how leading companies are modifying those practices as well as organizational structures across all facets of the business. Considering key legislative inputs – ahead of final rules – can help avoid surprises and may create a competitive advantage.

In the survey, "The Impact of Legislative Changes on Business Strategies," KPMG LLP (KPMG) explores many of the strategic elements impacted by legislative and regulatory change[3]. The results also signal leading practices organizations might use to incorporate legislative impacts to functional capabilities, organizational structures, and other key decision-making processes. Over 250 executives and board members identified their top concerns about how legislative and regulatory changes are impacting their strategic planning elements.

Top 5 strategic elements impacted by legislative and regulatory change



Impact of Legislative Changes on Business Strategies, KPMG LLP, December 2011

The interplay between "Innovation and Investment" and the other top five elements identified in the survey is as complex as the regulations that govern them. Either individually or taken together, the sheer volume of legislative and regulatory changes influencing these top five elements can be overwhelming. As an example, research and development (R&D) tax credits or depreciation guidelines could influence decisions about the technique and timing of innovation and investing in a new product or a new market.

Regulation Driving Strategy

"Regulation is becoming a driver of strategy. History tell us that periods of significant regulatory changes are usually followed by periods of increased M&A activity, new products, and other changes in industry dynamics."

Heath Tarbert, Partner
Weil, Gotshal & Manges LLP
Source: Directors Roundtable Institute event at Harvard Business School sponsored by KPMG LLP and Weil, Gotshal & Manges LLP

[1] Confronting Complexity, kpmg.com, KPMG International, January 26, 2011

[2] Staying Ahead of Public Policy and Regulatory Changes, KPMG LLP, March 2011

[3] KPMG surveyed over 250 executives and board members of companies primarily based in the United States in December 2011. The board members were divided a third and two-thirds between public and private companies and 34 percent serve as the audit committee chair. A total of 26 percent of all respondents were in the financial services sector; however, no other sector represented more than 9 percent of the survey population.

Tax Planning and the Tax Policy Debate

"Audit committees will want to ensure that their company's tax function is fully engaged in monitoring the tax reform debate as it unfolds, and modeling potential consequences—on R&D, capital investments, cash flow, hiring, compliance, and more—as well as possible remedial actions as the proposals become more specific. The serious debate over tax reform appears about to begin."

Prospect of Tax Reform Highlights Oversight Challenges, NACD Directorship, Dennis T. Whalen, Partner, KPMG LLP and Harry L. "Hank" Gutman, Principal, KPMG LLP, December 2011

Consequently, companies are learning the value of creating a legislative watch list. Prioritizing the top 5–10 issues that may critically impact an organization, its suppliers, or customers into a "watch list" helps ensure that critical issues are not being overlooked or simply relegated to stand-alone compliance discussions. The watch list may be different for each organization but can be an effective guide for applying a legislative lens to regular business discussions.

Leading Practice: Establish and Monitor a Legislative Watch List

Rigorous use of a legislative watch list as a guide to anticipate business impacts will help keep efforts focused on the most critical and up-to-date elements. Periodically update business scenario analyses that specifically address evolving influences from a legislative watch list.

Most watch lists today typically include tax planning given the legislative dialogue surrounding tax policy. It is therefore not surprising that "Adjustments to Tax Planning and Legal Structures" ranked high in survey concerns. Continuing tax reform debates around U. S. corporate tax rates including repatriated cash rules, R&D, or depreciation will likely impact investment alternatives and the return on investment (ROI) in many different ways. Using scenario analyses to evaluate the alternatives based on a variety of assumptions is emerging as a leading practice. Business analyses or frameworks that apply a critical public policy lens across the organization including customers, employees, business partners, and supply chains, in advance of final rules, can help highlight risks and opportunities as the tax debate unfolds. This advance dialogue can equip an organization to move quickly as final rules are introduced over an extended period of time.

Leading Practice: Employ a Tax Planning Framework

Establish a framework to periodically reevaluate the directional impact of relevant tax policy changes on business decisions in addition to the traditional compliance focus.

In addition to tax planning, respondents ranked the "Search for M&A Opportunities" among the top strategic elements most impacted by legislative and regulatory changes. Updating the approach to M&A analyses may be another good illustration of how leading companies are adapting to the new "normal" of the uncertain legislative environment. For example, the due diligence process for an M&A deal would traditionally include a compliance review of the legislative backdrop potentially affecting the transaction strategy. However, in this new environment, regulations are still evolving and will do so for a number of years to come. Consequently, the new transaction analysis may also need to incorporate modeling the potential long-term effects of the most critical of the hundreds of pending rules across many highly regulated geographies.

Major legislation such as Dodd-Frank and healthcare reform[4] has multiple implications for M&A. While evolving rules may alter compliance costs included in cash flow analyses, industry transformation driven by legislative changes may also offer unique opportunities. As an example, key provisions unfolding in the Dodd-Frank Act[5] such as those involving conflict minerals, derivatives, or the Volker Rule may alter the future revenue potential of

[4] The "Healthcare Reform" legislation is the product of two bills: Patient Protection and Affordable Care Act (PPACA), Pub. L. No. 111-148, March 23, 2010 and Health Care and Education Reconciliation Act of 2010 (HCERA), Public Law No: 111-152, March 29, 2010, and continues to evolve as mandatory and pending regulations are finalized over the next 5–7 years.

[5] For a fuller discussion of governance provisions in the Dodd-Frank Act, refer to Dodd-Frank: Beyond Financial Services—The implication and effects on nonfinancial service companies, KPMG LLP, July 2011

Incorporating Legislative Considerations into Functional Capabilities

"The past decade has not been easy on the CFO. Erratic markets, disruptive technologies, and a complex web of new regulations and compliance issues have forced the finance function to redefine its role in the organization."

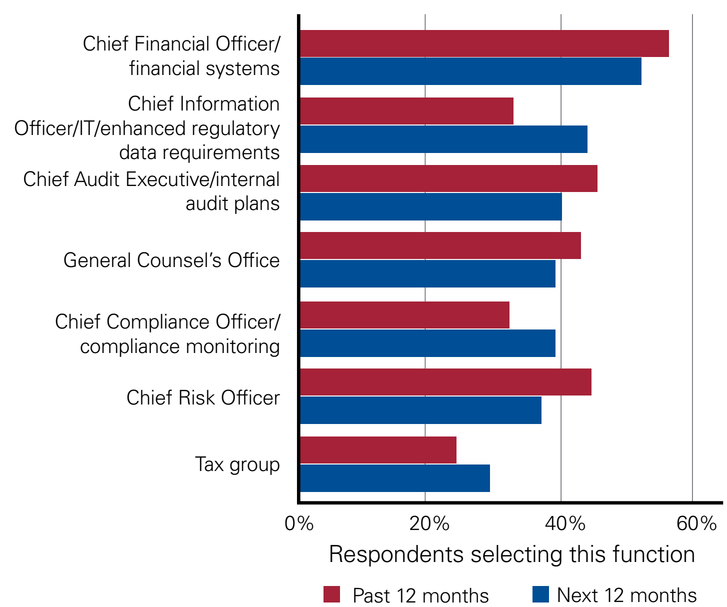
Transforming Finance – Challenges and breakthrough solutions for CFOs, KPMG International, March 2011

a proposed transaction or open up the competitive field of an industry. Provisions that have potentially significant consequences to an M&A strategy would likely be found on a watch list and would become part of the strategic dialogue around both M&A and emerging market investments.

"Emerging Market Investments" can expose companies to new short- and long-range risks as rules shift within and among different countries. In fact, cross-border regulations are changing at a faster pace in emerging markets than in more developed countries[6] creating even greater pressure to preemptively incorporate regulatory and compliance analysis into strategic discussions. This also includes changing tax policies, business practices, or foreign direct investment rules. So if organizations are expanding in emerging markets, monitoring significant local regulations is important but so is evaluation of the corruption index[7] and risks of violation of the Foreign Corrupt Practices Act or the UK Bribery Act[8]. And, as global tax authorities continue to focus on a coordinated approach to tax compliance, and governments struggle with deficits, cross-border tax risks also should be closely monitored on a watch list.

But as business leaders apply a new regulatory lens to strategic planning, survey respondents indicate that previous efforts to recalibrate traditional organizational structures and capabilities may not be adequate for the long term. Establishing an interdisciplinary process to evaluate the impact of regulatory change beyond simple compliance across business units can provide an early warning system for unintended consequences to business strategies. As legislative and regulatory change continues to stress companies' infrastructure, they are now reevaluating or creating new capabilities and organizational structures that will better align functional capabilities with strategic demands.

Functions most likely to be modified in response to legislative changes



Impact of Legislative Changes on Business Strategies, KPMG LLP, December 2011

Not surprisingly then, nearly all of the survey respondents indicated they were making changes to key C-suite positions as a result of their view of the regulatory road ahead.

[6] Confronting Complexity, kpmg.com, KPMG International, January 26, 2011

[7] Transparency International, November 2011

[8] Global Anti-Bribery and Corruption Survey 2011, KPMG LLP, June 2011

Changes to roles, responsibilities, training, and awareness either over the past or coming year were common to most responding companies. Many organizations had already made changes to the Chief Financial Officer (CFO) and Chief Information Officer (CIO)/IT function over the past year, and about half indicated that more changes to these positions were expected in the coming year. In addition, the risk officer and tax function positions were also clearly expecting significant change over the next 12 months.

Leading Practice: Adapt Roles and Responsibilities

Periodically reevaluate the roles and responsibilities for key control positions to ensure capabilities are keeping pace with legislative and regulatory developments.

The demand for CFO capabilities over the past several years has greatly expanded in response to both economic and legislative complexity. Survey respondents clearly expect the function to continue to play a significant role in the new regulatory environment. As an example, an increase in regulatory scrutiny, and pending and enacted Dodd-Frank governance and whistle-blower provisions[9] are highlighting the need for CFOs to expand the dialogue beyond traditional finance function to cross-functional impacts to business strategies. In addition to managing the volatility in the global market, the CFO now has to work more closely with the tax director to manage the business implications of evolving international and domestic tax policies that may have critical impacts on compliance budgets, investments and expansion, as well as increasing disclosure requirements around cyber security and sovereign debt exposures[10].

Additionally, a recent poll showed that the function now accountable for data integrity and governance has begun to shift from IT/CIO/CTO functions to CFO/business units. As a result, accountability is now equally shared between both functions[11]. Leading CFOs are now seizing the opportunity to reposition organizations to leverage changing regulatory requirements and respond more rapidly to external change.

As the survey indicates, market dynamics and legislative changes are also driving new demands for the role of CIO and the IT function. CIOs are now called upon to evaluate not only the business implications of initiatives enabled by technology but also understand the legislative impact of new and pending privacy and security legislation[12] on new products and other initiatives that may not originate with IT. Notably, Sales, Marketing, or other business units may be more likely to initiate social media or cloud-based programs. Two recent incidents of privacy exposure that occurred in social media companies resulted in strong product brands being heavily criticized in the press for the use of customer data. Integrating the IT strategy and CIO perspective into early strategic marketing discussions and including a review of privacy legislative changes early in the process is becoming a more common practice.

Leading Practices: Integrate Legislative Considerations into IT Strategic Practices

Update IT strategies to consider how legislation affecting the use of technology, such as privacy and cyber security regulations, might impact business strategies.

[9] Public Policy Alert: Legislative Complexity Challenges Traditional Business and Compliance Strategies, KPMG LLP, July 2011

[10] www.sec.gov

[11] Audit Committee Institute Roundtable, "Game-Changing IT and Other Developments Driving the Agenda", KPMG LLP, September 2011. Of the 313 respondents across the United States, 23 percent were Audit Committee Chairs and 25 percent more were Audit Committee or Board members.

[12] Public Policy Alert: Focus on information protection intensifies as market forces and regulatory disclosure requirements increase, KPMG LLP, December 2011

In addition to monitoring the viability of business partners who rely on federal funding[13], CIOs of companies who also contract with the federal government are obligated to meet not only technology requirements but also adhere to rigorous regulations specific to federal contracting. Failing to comply can expose new products, markets, or supply chains to unintended risks. As an example, having an IT function that understands the application and enforcement of the Federal Information Security Management Act (FISMA), a key tenet in the Administration's war on government fraud[14], may provide a more robust perspective to IT controls and business risk assessments.

Additionally, the IT function is called upon to weigh in on the business implications of key data drivers stemming from regulatory change. For instance, health insurance and information exchanges required by healthcare legislation and governed by enhanced HIPAA/HITECH[15] privacy enforcement will store and transmit more private information to different business partners than ever before. The CIO and IT functions with the right business acumen, data management, or intelligence processes and resource capabilities will find their way to the top of the competition.

Yet very few board members (10 percent) were willing to classify their company's strategic planning process as "very effective" in dealing with the pace of innovation and technology change in the business. And many indicate that the technical updates they do receive do not provide enough information from the right sources to adequately oversee the business risk of IT. Not surprisingly then, the CIO is the leading position with which the Audit Committee would like to spend more time[16]. As a result, adapting the capabilities of the CIO and IT function in this new regulatory environment is essential.

Another organizational change that surfaced in the survey addresses the corporate response to the Security Exchange Commission's bounty program for whistle-blowers. Nearly all respondents indicated they had already made, or will make in the next year, changes to whistle-blower programs in response to the Dodd-Frank Act[17].

Changes to whistle-blower practices in response to legislative and regulatory change

Impact of Legislative Changes on Business Strategies, KPMG LLP, December 2011

[13] The federal government touches nearly 40 percent of U.S. companies in its supply chain and spends over $400B per year not including stimulus spending since 2008.

[14] Public Law 111–204, Improper Payments Elimination and Recovery Act of 2010 (IPERA), together with the Executive Memorandum of June 18, 2010, Enhancing Payment Accuracy Through a "Do Not Pay List", www.whitehouse.gov

[15] HIPAA refers to the Health Insurance Portability and Accountability Act of 1996 Privacy and Security Rules which were expanded by the Health Information Technology for Economic and Clinical Health (HITECH) Act, enacted as part of the American Recovery and Reinvestment Act of 2009, which together provide a framework for privacy and security of healthcare related information. http://www.hhs.gov/ocr/privacy/

[16] KPMG's 2011 Public Company Audit Committee Survey, ACI, October 2011

[17] Defining Issues®: SEC Adopts Final Rule for Dodd-Frank Whistle-Blower Provisions, KPMG LLP, June 2011

The new provisions for whistle-blower bounties may influence key strategic decisions such as where to invest and with whom to contract as non U.S. entities and third parties such as independent contractors or venture partners are included in the population of prospective whistle-blowers. This exposure may be partially what is driving companies to invest in training and awareness for employees and business partners, new risk management measures, as well as enabling technology associated with whistle-blower processes.

As an example, companies pursuing new geographies and business partners may identify a simple need to expand background checks and whistle-blower facilities to third parties and in multiple languages. In spite of this leading practice, half the companies in the United States do not periodically train or certify third parties on the company's anti-fraud policies[18]. Companies with cross-discipline groups that include regulatory analysis, ethics, compliance, and human resources in their business strategy discussions will recognize the value of providing facilities and training that meet local needs and take into consideration the broader population impacted by whistle-blower, anti-bribery, and corruption requirements.

Similarly, global organizations dealing with ever-changing cross-border tax policies need to address global transparency, tax examination, and audit activities to comply with tax regulators across the globe. The risks for noncompliance are significant and the incentives for tax whistle-blowers can also be substantial[19].

Nearly all (91 percent) of survey respondents agreed that legislative and regulatory change will continue to impact business decisions. As a result, companies are readdressing the traditional approach of assessing compliance, tax, IT, and business strategies separately. Instead, leading companies have begun to integrate analyses of legislation and regulation into the business decision process and board discussions in a more structured manner. Companies are now adapting to long-term legislative complexity by applying a broad regulatory lens across all facets of the business planning processes. This shift repositions the concerns about legislative and regulatory change from a compliance exercise to an integrated part of overall business strategy.

[18] Global Anti-Bribery and Corruption Survey 2011, KPMG LLP, June 2011

[19] www.irs.gov/compliance/article/0,,id=180171,00.html

Leading practices to integrate regulatory changes into strategic discussions

Leading practice	How this practice helps
• Establish, prioritize, and employ a legislative watch list. Periodically update business scenario analyses that specifically address evolving influences from a legislative watch list.	• The pace and interrelated nature of new legislation is complex. Rigorous use of a legislative watch list as a guide to anticipate business impacts will help keep efforts focused on the most critical and up-to-date elements. Business scenarios that incorporate the impact of legislation germane to customers, employees, business partners, and supply chains can help highlight potential risks to acquisition strategies, budgeting and forecasting, and hiring considerations.
• Readdress the traditional approach of separately assessing compliance, tax, IT, and business strategies.	• Establishing an interdisciplinary process to evaluate trends in the impact of relevant regulatory changes across business units can provide an early warning system for unintended consequences to business strategies.
• Consider the affects that increased enforcement and costs of noncompliance will have on the organization, government contracts, and the viability of business partners.	• US government spending touches nearly 40 percent of US companies. Increased enforcement of US contracting rules could affect contracts, revenue streams, and discount programs in the company, business partners, and throughout the supply chain.
• Establish a framework to periodically evaluate the directional impact of relevant changes in tax policy on business decisions in addition to a traditional compliance focus.	• Using a policy framework can help position the business strategy to move quickly as tax policy debates are resolved and avoids repetitive or ineffective modeling.
• Periodically reevaluate the roles and responsibilities for key control positions to ensure capabilities are keeping pace with legislative and regulatory developments.	• Interrelated and overlapping legislature now demands a more integrated view of influences on business decisions in order to manage both intended and unintended consequences.
• Update IT strategies to consider how legislation affecting the use of technology, such as privacy and cyber security regulations, might impact business strategies.	• IT strategies now have to account for new data needs, new media, as well as the impact of legislation on data needs and data use. Even the most sophisticated companies are recalibrating governance over IT risk to create a more holistic view rather than use a traditional siloed approach.

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