

TACKLING 2021'S GREATEST BOARD LEADERSHIP AND GOVERNANCE CHALLENGES

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Your presenters



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Agenda

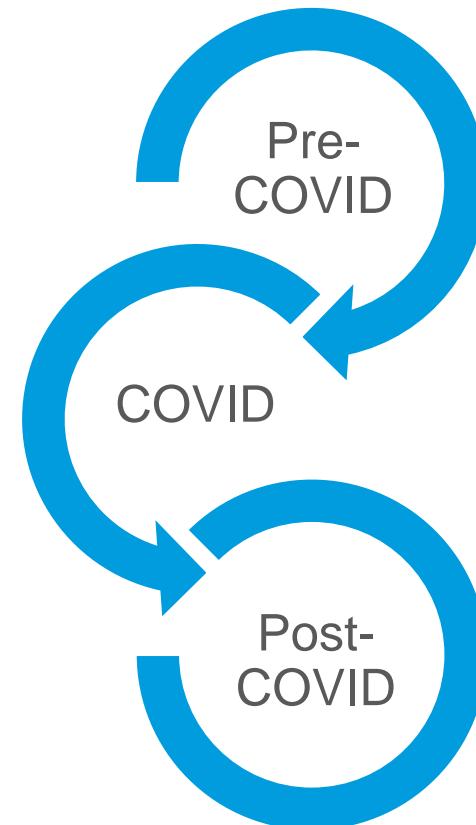
- Introductions – 3 minutes
- Regulatory update – 12 minutes
- Change management implementation suggestions – 20 minutes
- M&A deal market for 2021 – 20 minutes

REGULATORY UPDATE

Focus during this time of transition

Transition

tran·si·tion (noun): passage from one state or stage to another



New, complex and evolving situations

“Regardless of how much things change...the Commission’s principles-based approach to disclosure can be applied to new, complex and evolving situations. Significant examples include Brexit, the upcoming LIBOR transition, cybersecurity developments, climate change, and most recently, the global coronavirus (COVID-19) pandemic we are battling today.”



Former Director – Division of Corporation Finance

William Hinman

November 18, 2020

SEC focus area

- Critical audit matters
 - Should utilize entity-specific, useful information
- Cybersecurity incidents
 - Material information should be disclosed
- LIBOR
 - Understand management's plan to address risks associated with reference rate reform
 - Understand impact on financial reporting and contracts that reference LIBOR

On the SEC radar: ESG disclosures

“It’s time for the SEC to lead a discussion—to bring all interested parties to the table and begin to work through how to get investors the standardized, consistent, reliable, and comparable ESG disclosures they need to protect their investments and allocate capital toward a sustainable economy.”



Commissioner (now Acting Chair of the SEC)

Allison Herren Lee

August 26, 2020

Amended regulation S-K item 101(c)

- Addresses some ESG factors
 - Resources material to a registrant's business, such as sources and availability of raw materials
 - Government regulation – material effects that compliance with government regulations, including environmental regulations, may have on capital expenditures, earnings and competitive position
 - Human capital – Description of the registrant's human capital resources, including any human capital objectives the registrant focuses on in managing the business

Polling question #1

How would you describe your company's ESG-related disclosures?

- a) Our disclosures have reached robust levels
- b) Our disclosures are robust with respect to governance, but not with respect to environmental or social factors
- c) Our company takes steps to improve ESG transparency each year
- d) Our company likely will not increase ESG-related disclosures until the SEC mandates them

A principles-based approach

“A healthy perspective is to view corporate disclosure as an opportunity to engage and build trust with shareholders as opposed to an obligation or requirement to be minimized. Disclosures that are transparent, accurate, balanced and fair can build shareholder loyalty and serve long-term company interests.”



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2020 audit committee transparency barometer

- Gauges how audit committees approach public communication of their external auditor oversight activities
- Highlights
 - Some companies provided transparency into the board's approach to navigating COVID-19 and its impact
 - As more auditor reports include CAMs, more audit committee disclosures related to CAMs may begin to appear in proxy statements

- Cybersecurity disclosures have increased dramatically over the last five years
 - Is the audit committee responsible for cybersecurity risk oversight?
 - Does the board of directors have a cybersecurity expert?
 - On what board committee does the cybersecurity expert serve?

Examples of expanded reporting in 2020 proxies

- Audit firm selection/ratification
 - GATX Corporation
- Audit firm compensation
 - Spire Inc.
- Audit firm evaluation/supervision
 - Owens & Minor, Inc.
- Audit engagement partner selection
 - Citigroup Inc.

Mitigating the risks of common fraud schemes

- Anti-fraud collaboration study of common financial statement fraud schemes
 - Based on an analysis of SEC enforcement actions
- Most common types of fraud
 - Improper revenue recognition
 - Manipulation of reserves
 - Inventory misstatement
 - Impairment issues

Common fraud factors

- Business challenges
 - Pressure to meet analyst expectations
 - Increased supplier costs
 - Slowing demand for products
- Company culture
 - Tone at the top
 - High-pressure environment
 - Lack of adequately experienced personnel

Keys to protecting companies against fraud

- Vigilance
 - Evaluate the efficacy of internal controls
- Continued resolve to exercise skepticism
 - Be attuned to both quantitative and qualitative metrics
- Remain focused on the fundamentals
 - Controls, processes and environments that impact financial recordkeeping and decision-making
 - Company-specific risks identified through regular risk assessments

CHANGE MANAGEMENT IMPLEMENTATION SUGGESTIONS

Objectives

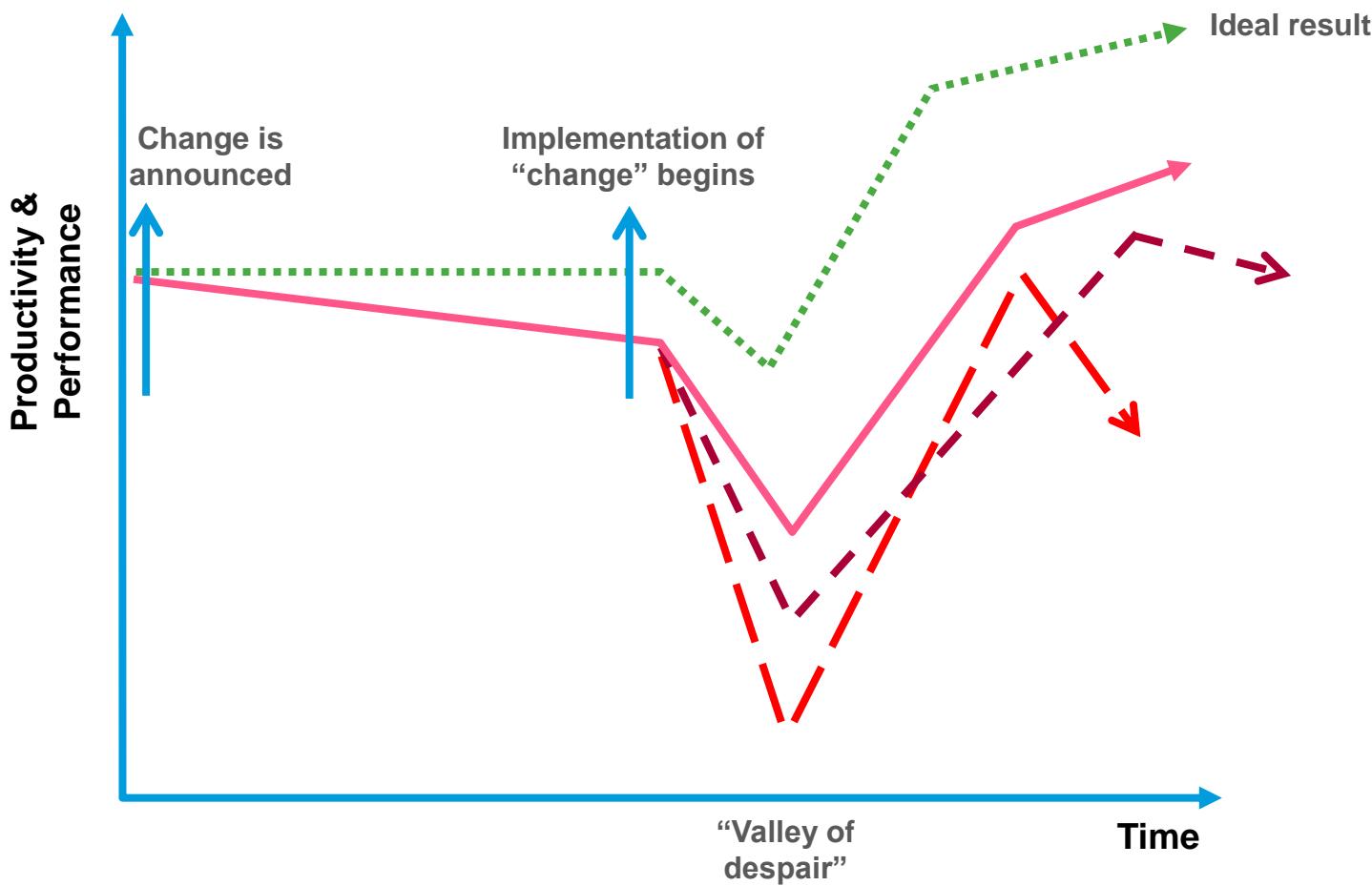
By the end of this topic, together we can....

- Examine the linkage between Organizational Change Management (OCM) and the delivery of measureable value
- Understand three areas that can accelerate the time to value during times of organizational change

“Change is hard because people overestimate the value of what they have – and under estimate the value of what they may be gaining by giving that up”

- James Belasco and Ralph Stayer

When “change” occurs, productivity “dips” and costs rise



So, if productivity and performance **ALWAYS** dips – then **VALUE** is always lost?

Change is a “process” not an event.....People who go through ANY change experience have common reactions, these reactions can be predicted, managed and measured as outcomes.

Behavior value analysis – Client example

What is the strategic objective driving “change”?

To implement a new technology that automates route planning

How do the benefits break down?

Financial benefits

What are the primary benefit drivers?

Decrease transportation costs

Decrease vehicle maintenance costs

What are the specific targets?

28% decrease in miles driven by terminal

20% reduction in tires and maintenance cost

20% reduction in fuels costs

What behaviors are required?

Drivers must log all arrival and departure times for every stop

Drivers must meet the 15 minute time limit from punch in to terminal departure

Drivers must not re-load their trucks once loaded by freight handlers

Dispatchers must use system to configure final routes with no manual intervention

What KPIs will need to be measured?

% of drivers who log starts and stops real time

% of drivers who depart terminals under local contract terms

of deliveries that matched customer quoted delivery date and time

Non-financial benefits

Death, taxes, and resistance to “change”



By [Henna Inam](#) Posted February 26, 2017 In [Coaching Tool-Kit](#)

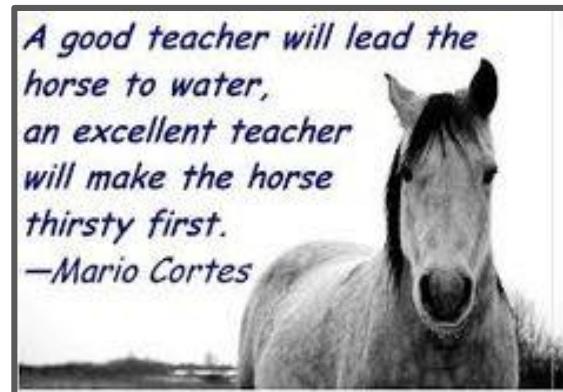
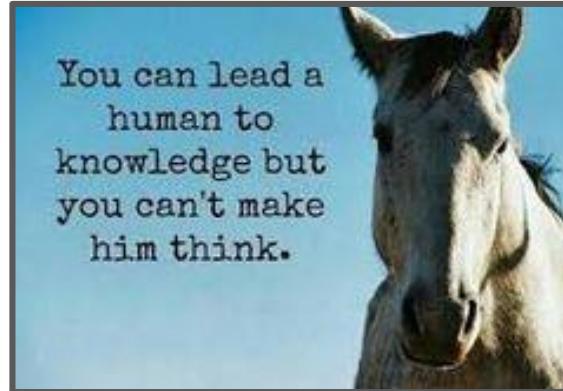
“The most dangerous phrase in the language is ‘we’ve always done it this way’”

-- Grace Hopper

Five universal truths on “resistance to change”

1. **Resistance** is unavoidable during times of change
2. Number 1 cause of **resistance** is the reality or perception of a loss of predictability and control
3. Two types of **resistance** – overt or covert – covert is far more damaging and time consuming
4. **Resistance** is the boat anchor on any journey to **value delivery**
5. **Resistance** must be uncovered so it can be minimized!

Resistance can be addressed and minimized



To minimize the drop in performance and the recovery to a higher likelihood of 'change' adoption, **AND PERFORMANCE** - the 'change' has to be accepted by a majority of the stakeholders (2/3)

- *Track feedback consistently; listen for "FUD" (Fear, Uncertainty, and Doubt)*
- *THANK anyone who "OVERTLY" RESISTS change and openly questions the approach or project*
- *Identify, leverage and engage KOLs (key opinion leaders) early*
- *Make the student the teacher (KOLs who are **resisting the "change"**)*
- *Don't forget the "why", the "WIIFM", and a dose of "**pain messages**"*

Remember: People will begin to change if the pain of the current situation is greater than the anticipated pain of having to change (remember back to the early days of Covid)

Change fatigue is a value destroyer

Higher performance is about consistently putting the right people, with the right skills, in the right roles, doing the right work, at the right time

If everything is critical,
nothing is critical

1. Prioritize projects; base it on planned value

- Clear the way for highest value initiatives that drive strategic goals
- Be willing to stop or postpone projects of lesser value
- Alignment equals greater Speed

Alignment increases speed

2. Re-visit strategic intent

A. Why does our company exist?

B. What do we want to be known for and by when

- Identify 3-5 strategic imperatives
- Define what your strategic imperative are AND what they are not – enforce prioritization and cascade throughout the organization

Polling question #2

From a board perspective, which of the following are true

- a) Change should be lead as a “process” not a one-time “event”
- b) Accelerating time to value should be a key concern on all organizational change imperatives
- c) Lack of project prioritization can either delay or prevent business case benefit delivery for organizations
- d) None of the above
- e) All of the above

Polling question #3

Have you been involved in an M&A transaction within the past 3 years?

- a) Yes
- b) No

M&A MARKET 2021

Market update and key items for consideration

M&A market - Agenda

- M&A outlook
- What is a quality of earnings report
 - COVID-19 impact on financial performance
- Synergies
- Top tax considerations for deals in 2021
- People and culture
- IT and cyber M&A considerations

- Deal activity recovered from Q3 to Q4 as quarterly deal activity grew from \$125bn to \$176bn, and amounted to \$561bn TYD
- Deal output in 2020 was soft compared to pre-pandemic levels
 - Q2 had only \$97bn, which is the lowest reading since 2016 when \$80bn was observed
 - Still, this is far better than some had predicted amid the initial COVID-19 lockdowns that sidelined in-person meetings

M&A outlook (cont.)

- Recently, there has been a trend toward smaller check sizes
 - Add-ons amounted to roughly 64%, which is the largest reading by far over the past 14 years
 - Add-on acquisitions are attractive in a bearish economy, because they tend to be less risky since an investment has already been effectuated
 - In addition, many portfolio companies and corporate acquirers – and especially those in retail, hospitality, and real estate – have suffered financially which leads them to refocus on existing rather than new investments

M&A outlook (cont.)

- As we look ahead to 2021, we expect more deal activity resulting from:
 - low interest rates,
 - central bank stimulus and
 - overall improved economic conditions
 - In addition, private equity firms are sitting on significant amounts of cash, which will be needed for struggling companies needing another dose of capital

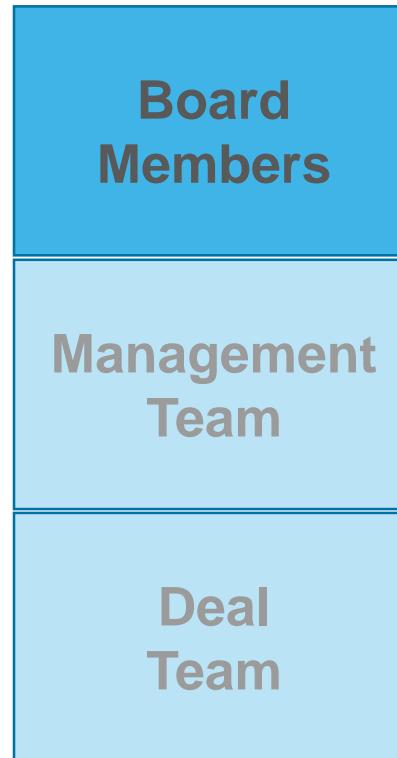
Polling question #4

Do you plan to be a part of an M&A transaction within the next year?

- a) Yes
- b) No

QUALITY OF EARNINGS

An objective assessment of financial performance and position



Why are they useful?

- Assess cash flows used in valuation
- Identify deal risks and opportunities
- Inform integration planning and strategy

What are the benefits to board members?

- *Supports fiduciary responsibilities*
- Independent from internal assessments
- Can help challenge or support valuation



COVID-19 IMPACT

COVID-19 continues to be a key focus of diligence efforts

Immediate	Near-term	Long-term
<p><i>Identify cash flow matters and exposures</i></p> <ul style="list-style-type: none">• Shutdowns• Loan forgiveness• Furloughs / layoffs• Demand shocks• One-time costs	<p><i>Consider short-term impacts into valuation</i></p> <ul style="list-style-type: none">• Capacity / utilization• Supply constraints• Input cost trends• Run-rate safety costs• Run-rate IT costs	<p><i>Assess fundamental changes to future state</i></p> <ul style="list-style-type: none">• New ways of working• Adaptability• Route-to-market• Facility footprint• Demand shifts



SYNERGIES – ARE THEY REAL?

Making the right investment

- Deal theses frequently depend on achieving certain cost or revenue synergies, without which the buyer may not be able to justify the multiple and purchase price
- Proper analysis of proposed synergies and related value levers during the diligence process could mean the difference between whether or not to move forward with the purchase, and at what price

Making the right investment (cont.)

- Considerations include:
 - **M&A Strategy:** How does the acquisition best complement the capabilities of the buyer? Will the acquisition be fully integrated, partially integrated or standalone, and where will it sit within the overall business?
 - **Target Operating Model:** How can the business best serve its customers and stakeholders? Which functions and activities should be centralized versus maintained at a segment or region level? Which capabilities are core to the business and which should be outsourced?
 - **Integration and Separation Risk:** Can the deal strategy and synergies outlined be reasonably executed? What risks are posed by internal and external factors that might influence various scenarios?

Synergy and cost saving roadmap

Programs should follow a structured synergy process to identify, size, select, execute, and track cost synergy opportunities

	Gate 0 Hypothesis Generation	Gate 1 Initial Quantification	Gate 2 Alignment & Approval	Gate 3 Detailed Business Cases	Gate 4 Implementation Roadmap
Proposed Due Date	Week 1	Week 2	Week 3	TBD	TBD
Inputs	<ul style="list-style-type: none">• Kick-off Discussions• Planning Sessions• Combined Cost Baseline• Synergy Targets	<ul style="list-style-type: none">• Refine Combined Cost Baseline, as needed• Functional benchmarking and activity KPI comparison• Integrated, future target operating model	<ul style="list-style-type: none">• Refine synergy estimates based on crossfunctional alignment• Executive leads approve opportunities based on complexity and size	<ul style="list-style-type: none">• <i>Determine action owners, define timing and refine cost to achieve, as needed</i>	<ul style="list-style-type: none">• <i>Define interdependencies, risks and issues</i>• <i>Establish reporting mechanism and cadence</i>
Output	<ul style="list-style-type: none">• List of synergy opportunities by function and activity with related addressable spend baseline and cost savings hypothesis driver• Dependency list and additional data requests	<ul style="list-style-type: none">• Synergy estimate range• Preliminary estimate of cost to achieve, complexity and timing	<ul style="list-style-type: none">• Approved list of opportunities to build business cases• Completed synergy initiative analyses with updated cost savings estimates	<ul style="list-style-type: none">• <i>Business cases with owners, costs aligned to budgets and financial reports and related timing</i>	<ul style="list-style-type: none">• <i>Value Creation roadmap</i>• <i>Cross-functional project plan</i>
Stakeholder	Functional Leads	Functional Leads	Executive Leads	Executive Leads	Functional Leads



TAX

Top tax considerations for 2021 transactions

- Net operating loss (“NOL”) limitations due to ownership change
 - Annual limitation applies to use of NOLs following a greater than 50% change in ultimate ownership over a rolling three-year period
 - IRS proposed regulations, if adopted, may substantially reduce annual limitation, especially for non-capital intensive businesses
 - Low interest rate environment also reduces limitation
 - Consider carryback and carryforward potential in light of historical and potential future tax rate changes
- Interest deduction limitations made more restrictive by Tax Cuts and Jobs Act for tax years beginning in 2018 and after
 - Limit of 30% of adjusted taxable income (generally similar to EBITDA for tax years through 2021, but similar to EBIT thereafter)
 - CARES Act temporary increased to 50% of EBITDA for 2019 and 2020 (but only 2020 for partnerships, with increase to 50% applied at partner level for 2019)
 - Applies to foreign as well as domestic operations with complex grouping rules for U.S. consolidated and controlled foreign corporations
 - Critical to consider debt allocation as part of an acquisition, including potential advantages to allocating debt to foreign subsidiaries
 - Pushing down debt post-acquisition may have adverse tax consequences and may not be possible commercially

Top tax considerations for 2021 transactions

- CARES Act Payroll Protection Program (“PPP”) loans and Employee Retention Credits (“ERC”) against payroll taxes
 - Significant due diligence issues around PPP loan forgiveness and entitlement to and quantification of ERC
 - Consolidated Appropriations Act (12/27/2020) permits deduction of expenses properly paid with PPP loan proceeds, contrary to former IRS position – resulting tax accounting issues
 - Legislation also liberalized the ERC and permits the same taxpayer to receive both ERC and PPP benefits
- Global Intangible Low-Taxed Income (“GILTI”) and Foreign-Derived Intangible Income (“FDII”) provisions for tax years beginning in 2018 and after
 - GILTI operates as a minimum tax on non-U.S. income
 - FDII provides a permanent deduction for certain types of foreign income
 - Significant due diligence issues around GILTI and FDII compliance and calculations for USMNCs under extremely complex regulations implementing the provisions
- Biden tax plan calls for increase in corporate tax rate from 21% to 28%, increase in GILTI rate from 10.5% to 21%, and addition of corporate alternative minimum tax
 - Retroactivity?
 - Deal model implications



PEOPLE AND CULTURE

Leadership & culture is critical to M&A success

- Culture was ranked as *the* most challenging “people” issue in M&A
- Assess and determine cultural synergies, establish vision for the future that will resonate
- Having the right leaders in place is the key to managing through transitions, identify effective people leaders and empower them
- Plan for organizational change and focus on employee engagement to reach objectives



IT & CYBER

IT diligence: Overview

IT diligence seeks to answer: Is the target stable, scalable, and able to be integrated into my environment? Further, is there additional value we can extract beyond the investment thesis?

- 1) Unplanned CapEx remediation
- 2) Prior acquisition integration remediation
- 3) Cost takeout opportunities

IT diligence: Unplanned CapEx remediation

- Are there immediate needs for license, server, workstation, or network equipment changes?
 - End of life systems, databases, or operating systems
 - Workstations or servers > 3 – 5 years old
 - Network equipment beyond serviceable lifespan
- It is not uncommon to see 200-500K of costs, sometimes significantly more

IT diligence: Prior acquisition remediation

- Is there OpEx burden or process burden related to unintegrated systems or IT environments?
 - Unintegrated HRIS, Payroll, Time, and Expense
 - Unintegrated ERPs, Billing, or Order Management
 - Unintegrated Customer Portals, BI tools, FP&A
- The more acquisitive the target was, the more likely remaindered costs exist. Cost to remediate can be in the millions.

IT diligence: Cost takeout opportunities

- AWS / Azure (Cloud) migration
 - Avoid the next major CapEx
 - Gain additional margin by optimizing server config.
- Consolidate licenses
 - Microsoft O365 discounts from Parent to Child
 - ERP cost takeout via elimination and consolidation
- Optimize org structure
 - Offshore lower-tier IT services (E. Europe, Asia)
 - Reduce infrastructure team by contracting an MSP

Cybersecurity diligence: Overview

- Cybersecurity diligence assesses risk from external infiltration, internal bad-actors, third-party risk vectors, and regulatory obligations
- Most significant risks come from external infiltration (Ransomware) and regulatory obligations (GDPR, CCPA, PCI, HIPAA, et al)

Cybersecurity diligence: External infiltration

- Ransomware is on the rise. Prevention and detection are poor. And costs are rising.
 - What was a \$50K Bitcoin payment is increasingly \$1+ million
 - Dwell time (infection to detection) is 2+ days
 - Business disruption costs are highest in heavily automated environments (ex. Healthcare, Industrials)
- Integrated a breached target into your environment exposes you. Prior identification is critical to manage costs and exposure.

Polling question #5

Do you feel you receive sufficient information about a buy-side transaction at the board level to feel comfortable with the acquisition being made?

- a) Yes
- b) No

QUESTIONS AND ANSWERS



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