KPMG

Oversight amid economic volatility

KPMG Board Leadership Centre

Geopolitical instability and surging inflation sit atop the macroeconomic factors that corporate leaders must account for when making business decisions. Moreover, interest rates are increasing, and supply chains continue to be stressed. The risk of a global recession is high.

Oversight in this environment will require corporate boards to test the breadth of management's scenario analyses and its consideration of exogenous shocks.

Global GDP forecasts continue to point to a modicum of growth, but deceleration has been the theme of this year and is expected into 2023.

Few executives have experience with the economic factors at play today. It has been more than 40 years since we've seen inflation this high – and interest rates are increasing sharply at home and abroad. Even with the high levels of employment in the UK, companies must be cautious about the impact of inflation and rising rates. Does the board understand management's strategy, and the related risks, to maintaining a resilient organisation?

Directors should be prepared to probe management on the following issues in the coming months:

Scenario planning

After a relatively strong growth at the start of the year, the UK outlook looks increasingly fraught. The squeeze on consumer incomes has tightened with the increase in energy tariffs and the higher cost of food and other commodities arising from the conflict in Ukraine has pushed up the cost of living.

The economy is probably already in a mild recession with growth expected to stay negative into 2023. And, the Bank of England is expected to raise interest rates until it is absolutely certain that inflation has been tamed.

— Has the company modelled for a recession within the next several years?

— What scenarios has the company considered for supply/demand imbalances, pricing pressure and customer impact, commodity pricing and availability, and rising interest rates?

— Has the company evaluated its sensitivity to products and services heavily subject to inflation?

— How quickly can the company respond to shifts in customer behaviour?

— Does management prepare probability scenarios for how the future might unfold and consider the threats and opportunities that those scenarios present?

— Do the strategic options balance a commitment to a course of action with the flexibility to adjust amid different future scenarios, including different risks and economic realities by region?

Growth, capital allocation, and resilience

In the UK, inflation is outpacing wage growth, which will dampen consumer spending to some degree. Together with a higher cost of capital due to higher interest rates, companies should re-evaluate their growth initiatives, including financing, expected returns, and time horizons. Moreover, the interest rate environment will impact dividend policies and buyback initiatives.

— Has management discussed with the board its views on how inflation and rates influence capital allocation, including fixed investment, long-term contracts, and wages and incentives? What about the company's M&A outlook?

Fortress balance sheets will provide ballast for the most creditworthy companies to remain resilient in their operating environment and supply chains, but companies with thinner margins and more short-term financing will be challenged. Companies should also be planning for rollover risk for maturing debt due this year or next.

— What long-term growth initiatives are mission critical? Where might plans need to be adjusted and costs removed?

Building resilience – in operations, in supply chains, and on the balance sheet – requires money and may come head-to-head with the need to take costs out of the business.

Hedging against commodity, currency, and interest rate fluctuations

With more than two years of operating in an environment impacted by COVID-19 and supply-chain disruptions, companies have already adjusted sourcing and financing for many critical inputs. Now, emerging economic stressors have applied new strains.

— How might higher interest rates further impact hedging costs and long-term contracts? To what extent are customers and suppliers impacted by these forces?

— How is the availability of financing and insurance expected to be affected?

Fair value and asset impairments of businesses

Companies need to consider the accounting and financial reporting impacts of market volatility, the Ukraine conflict, and related sanctions.

— Do management understand how vulnerable the company's portfolio is to changes in value given inflation and higher interest rates?

— Has management identified triggering events that may warrant impairment assessments of long-lived assets, goodwill, and other intangible assets?

— How does market volatility impact the valuation of pension plan assets and planned or mandatory funding levels?

Environmental, social, and governance (ESG) initiatives

Shareholder expectations for corporate commitments to sustainability and diversity, equity, and inclusion have grown significantly. Rocketing energy and higher commodity prices have emphasised the financial underpinnings of these issues. Similarly, company commitments to employees, communities, and other stakeholders have a real cost and could become more challenging to implement.

— Does the board understand the potential material impact of its ongoing ESG commitments?

— Has the company focused on clear and timely communication to its stakeholders, including updates when plans and scenarios change?

While economic growth is put under stress, robust governance in the face of resurgent volatility will help keep the company strongly positioned for the future.

The KPMG Board Leadership Centre

The KPMG Board Leadership Centre offers support and guidance to non-executive directors, whether managing a portfolio non-executive career or embarking on a first appointment. Membership offers you a place within a community of board-level peers with access to topical and relevant seminars, invaluable resources and thought leadership, as well as lively and engaging networking opportunities. We equip you with the tools you need to be highly effective in your role, enabling you to focus on the issues that really matter to you and your business.

Learn more at www.kpmg.com/uk/blc.

Contact us

Timothy Copnell
Board Leadership Centre
T: +44 (0)20 7694 8082
E: tim.copnell@kpmg.co.uk