Audit committees brace for uncertainty, economic volatility and heightened risks

The convergence of economic and regulatory stressors is testing the resiliency of audit committees

By Paul Van Eyk

We're in a challenging business environment. The annual inflation rate in Canada is at its highest in almost 40 years. Central banks around the world are aggressively raising rates, supply chain disruptions persist and consumer demand that was strong during the strictest of the pandemic measures may taper off. According to the latest KPMG CEO Outlook, most Canadian CEOs (92%) believe a recession will emerge over the next 12 months.

Geopolitical and social forces are also impacting organizations. With the ongoing war in Ukraine, many European countries may face natural gas shortages through the coming winter as energy stability continues to be a challenge for many countries. The competition for skilled labour is intense and workers are demanding dramatic changes to work and the workplace. And stakeholders—including regulators—have new demands around the environment, social issues and corporate governance.

Even large companies with skilled management can experience difficulties in an environment like this because the macro factors move so quickly against them. Additionally, many management teams, boards and audit committees have never experienced the combination of a major recession, inflation at these rates, or interest rates at these levels.

With the potential for waning consumer demand, it's unlikely that companies will be able to sell their way out of this recession. We're moving from an era of growing revenue to maintaining profitability, which means audit committees will need to look below the top line and pay more attention to gross margins, costs, and profits.

Faced with so many challenges, many management teams and boards are busy putting out fires and attempting to appease every stakeholder. But they need to step back, carefully choose the most important stakeholders to satisfy and formulate a strategy to get through this environment, so they come out of it stronger in the longer term.

> "The cash flow statement is the most important statement in challenging economic times. Cash flow gets to the heart of going concern and companies can't hide from it.

Paul Van Eyk
Partner, National Service Line Leader, Restructuring & Turnaround, KPMG in Canada

As organizations prepare themselves for a recession, it's important that audit committees move their discussions toward what they need to hear and not what management thinks they want to hear. Audit committees should be adamant that their CFO report anything that's a concern and asking for a 'no surprise' approach to running the business.

Watch your cash flow

The cash flow statement is the most important statement in this environment. Management and boards must closely monitor cash flow; discussions of adjusted EBITDA need to be replaced with discussions of cash management. Cash flow is the simplest model for measuring the business and an indicator of emerging problems. A company either has cash or it doesn't; it's either flowing in from somewhere or out to somewhere and can signal that an organization's liabilities outstrip its assets. In difficult times, it should be reviewed frequently—even weekly—by senior management.

How the cash flow statement is built is just as important as the cash flow itself. Audit committees must ensure management is maintaining proper governance, controls and processes around cash flow reporting; that they have thorough understanding of their cash flow forecasting models; and that their assumptions and processes are reasonable.

Understand your debt

In the face of rapidly rising lending rates and a potential economic slowdown, organizations need to be sure they understand their debt and capital structure. Some organizations are already resetting their debt due to market conditions, and management should review their debt agreements and understand the covenants—including potential rate step-ups, reporting requirements and default triggers. Companies with sub-optimal balance sheets should prioritize exploring options for strengthening them. The audit committee should be sure that management understands the company's debt and has run reasonable scenarios around any changes.

Questions audit committees should be asking:

- Do we understand our cash flow forecasting tools and key operating statistics?
- Do we understand our debt structure going into a recession?
- Are we effectively managing our working capital and maximizing our liquidity?
- Are we being proactive in engaging our CFO, our lenders and other stakeholders?
- How do we manage the challenges of this environment while recognizing the opportunity to take advantage of transformation projects to lower costs or M&A to grow the business?

Keep the right people

During the pandemic, many people—including senior managers—revaluated their careers, working conditions and work-life balance. As a result, some companies have lost experienced management, and new leaders may not know the company's business as well; they're playing catch up and may not spot or understand patterns occurring in the business. When a CFO leaves, the role of the audit committee becomes critical because they have institutional knowledge that left with the CFO.

Audit committees need to ensure the organization has an adequate incentive and retention program to keep their best people, and a succession plan in the event they leave. A recession can be a lonely time for senior management, so audit committees should also keep up a high level of engagement.

Lean on the audit committee

The role of the audit committee has expanded beyond signing off on the audited financial statements to becoming a guiding light for the board as it navigates these challenging times. Audit committee members are typically the more financially-oriented than their boardroom peers and bring insight into managing liquidity, debt structures and the capital structure.

The stakes are high. A board resolution is required to be signed if a company is going through certain formal insolvency proceedings, potentially exposing officers and directors, and their decision making during difficult times. The audit committee may want to review their own structure and their own processes and procedures, and ask themselves if they have the right people on the committee, whether they have the resources they need and whether the committee, as it currently stands, is set up to weather these times. They shouldn't be afraid to ask for help if managing through uncharted waters.

Communicate frequently

In this environment, audit committees may find it difficult to move away from process and reporting but they should aim to be more proactive in their approach. This may mean monthly or even weekly meetings with the CFO, rather than waiting until the next quarterly meeting.

The audit committee should proactively ask the hard questions of management to gain insight and make the necessary oversight decisions. For instance, what are their key operating statistics? What are the key risks for the organization? Have they run scenarios to help manage around these? Are the procedures and assumptions used for the scenarios reasonable?

Organizations should also engage with key stakeholders. For example, their bank can be a valuable advisor and partner in helping navigate challenging times. Often, organizations wait too long and then must engage because they have a crisis.

Doing nothing is not a good strategy

A recession can be a good opportunity for the board to determine a strategy for the next one to three years. For instance, if the company has, or can build, a war chest, then it may be a good time to explore acquisitions as valuations fall for potentially distressed targets. On the other hand, if they don't think the organization can survive the recession then it might make sense to sell some or all of it.

Management should be looking for ways to take advantage of this environment; adapting to negative market forces can be a catalyst to become leaner. That means moving past fear of the situation and looking to build their balance sheet. Difficult economic times can build discipline within an organization, which can improve profitability. For instance, spending often gets questioned at every level and this can lead to transformative cost-cutting initiatives.

These can be daunting times for organizations. By paying close attention to their cash flow, understanding their debt and capital structure, and working to retain the right people, companies can emerge intact, if not stronger. The audit committee can play a key role by offering their financial expertise and ensuring that management is monitoring the right measures of business performance using sound processes and controls.

Explore the Accelerate article series

Contact us

Paul Van Eyk
Partner, National Service Line Leader
Restructuring & Turnaround
KPMG in Canada
519-747-8836
pvaneyk@kpmg.ca