

Audit committees can offer valuable insight and guidance

By Paul van Eyk and Pritesh Patel

Cracks are appearing in the foundations of corporate Canada. Bankruptcies are on the rise and the major banks are increasing their provisions for credit losses. Healthy cash flow is imperative in this environment and companies that have it may find new opportunities for growth. But companies that don't have it could face challenges—and their audit committees should be prepared for hard conversations about the company's ability to remain a going concern.

Companies face ongoing uncertainty and disruption

Supply chain disruptions and geopolitical tensions persist, and many companies are finding it difficult to recruit and retain skilled labour despite rising unemployment in Canada. In the months ahead we face increased energy cost uncertainty, we're expected to enter a new COVID wave and the 2024 U.S. presidential election will add uncertainty to the markets and the economy. Longer-term economic challenges may arise from growing protectionism, the disruption to the oil and gas industry, the shift to electric vehicles, and weaker labour productivity in Canada compared to our trading partners and competitors.

The most material economic factor for many companies is higher interest rates and the associated debt servicing costs. The speed and magnitude

of rate hikes by the Bank of Canada took many by surprise and brought the Bank's target lending rate to its highest level in more than 20 years. As consumer spending and GDP growth slows, uncertainty remains over the direction and timing of future Bank of Canada moves. This may prove to be a challenging environment for many CFOs who've only known cheap money and strong growth during their careers, so audit committees will play a crucial role in guiding these CFOs through this new reality.



Audit committees are the first line of defense. They need to start embracing the discussion of going concern with their auditors, and auditors need to be unafraid to have these discussions.



Many companies borrowed heavily during the period of record low interest rates. But now, with higher rates, some companies are finding it more difficult to service and re-finance their debt. Business insolvencies for the year ended August 31, 2023, increased by 36.7 percent compared with the previous year, and the Big Six Canadian banks are signaling concern about the future health of Canadian borrowers [1]. In the third quarter of 2023, these banks more than doubled their provisions for loan losses over the same quarter in 2022 [2].

Companies must assess going concern

With an increasing number of companies unable to meet their obligations, audit committees need to embrace the discussion of going concern with their auditors and press their CFO to demonstrate that the company is trending toward remaining a going concern. The audit committee is the first line of defense: The auditor doesn't enter the fray until three to four months after year-end closes, so if there's a falling knife, it needs to be caught by the audit committee and/or the board of directors.

Cash flow is the litmus test for any organization. It must be top of mind for audit committees, and they must ensure it's high on management's agenda as well. There's a lot of focus on top-line growth but profitability is not the same as cash flow. Companies with great sales can find themselves stressed if they're not converting these sales into cash because they're being tied up in working capital. The audit committee needs to look closely at the company's cost structure and debt structure, and engage the CFO in a discussion about cash flow and the processes in place to monitor it. If it's looking tight, they need to be asking about management's plan to improve the cash position. For instance, are they looking at cost reduction opportunities or are there working capital improvements that could be implemented? Start asking the questions you need to know, not want to hear!

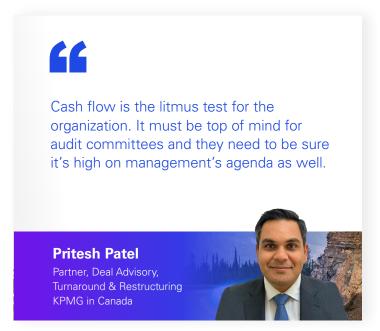
Now is the time for companies to have difficult discussions both internally and with their wider

stakeholder group. Engagement is key—audit committees should ensure management is engaging often and early with their banks, capital providers, customers and suppliers. The committee chair should meet regularly with the CFO and create an atmosphere of trust. Management should also be encouraged to regularly engage with employees throughout the company since they have insight into the operations and the health of the company.

A new cycle demands a new mindset

Boards and audit committees need to examine their own structures and personnel. We're in a different cycle, which will require a different mindset. The board may need a different complement of backgrounds, skills and temperaments. For instance, members who've been through a turnaround may offer valuable insight and guidance. There are many resources available for board member education, though it may be necessary to seek outside training or consulting to fill skills gaps. There is no scenario in which an audit committee can over plan for this cycle, all options and strategies need to be on the table.

Emotional intelligence will be more important than ever if audit committee members need to have



^{[1] &}quot;Insolvency Statistics in Canada — August 2023 (Highlights)," Government of Canada, Office of the Superintendent of Bankruptcy (website), accessed October 4, 2023, https://ised-isde.canada.ca/site/office-superintendent-bankruptcy/en/statistics-and-research/insolvency-statistics-august-2023-highlights

^[2] Denise Paglinawan, "-It's gonna get worse': Banks are bracing for bad loans, but the trouble is only getting started," Financial Post, September 8, 2023, https://financialpost.com/fp-finance/banking/banks-bracing-bad-loans-trouble-started

difficult discussions with the board and CFO—and be prepared to challenge management. If the company must fight to survive, then board members will have to make hard decisions such as laying off employees or selling parts or all of the business. They'll also need to recognize—preferably sooner rather than later—when it becomes necessary to seek outside help.

For companies that do have strong cash flow and are going to weather the storm, now may be a good time to grow the business. There may be opportunities to acquire targets at better valuations than were seen a few years ago. Some may have to sell because they're distressed, but this may be a case of an otherwise good company with a bad balance sheet. Some may not be in trouble at all, but are selling for other reasons such as succession. Audit committees that are assured by their CFO that the company is a going concern and has a strong balance sheet should ask management about its plans for growth to take advantage of this cycle.

A long cycle of strong economic growth and low interest rates has come to an end, and navigating the new economic realities ahead will require a



new mindset and new skills. Audit committees can offer valuable insight and guidance but must also be prepared for hard decisions. Not all companies will remain going concerns in this environment and it's critical that companies meet the challenge head-on.

Contact us

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

Pritesh Patel Partner, Deal Advisory, **Turnaround & Restructuring KPMG** in Canada 416-468-7923 pritpatel@kpmq.ca



