Five areas of oversight to consider amid economic volatility

Oversight in this environment requires boards to test the breadth of management's scenario analyses and consideration of exogenous shocks

Greater geopolitical instability and surging inflation have been added to 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. Oversight in this environment will require corporate boards to test the breadth of management's scenario analyses and its consideration of exogenous shocks.

While global GDP forecasts continue to point to growth, deceleration is expected this year and into 2023. And, according to the latest KPMG Global Economic Outlook, further escalation of the Russia-Ukraine war could exacerbate downside scenarios.

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—greater than 5 percent in many developed countries. Even at full employment in the United States ("U.S."), 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

U.S. GDP declined at a 1.4% annual rate in Q1 2022, an unexpected outcome given that consensus expectations pointed toward growth. Despite the miss, KPMG believes that the risk of a recession for the U.S. economy over the coming year remains low. However, others believe that quicker Fed moves on interest rates and less policy accommodation (e.g., reduction of the Fed's balance sheet) increases the risk of a recession in 2022.

- Have companies modeled 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 behavior?
- 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 U.S., inflation is outpacing wage growth, which will dampen consumer spending to some degree. Together with a higher cost of capital due to rising interest rates, companies should reevaluate 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 mergers and acquisitions 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.

Environmental, social, and governance (ESG) initiatives

Shareholder expectations for corporate commitments to sustainability and diversity, equity, and inclusion have grown significantly. Higher energy and 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 these constituents, including updates when plans and scenarios change?

While economic growth is expected to continue, the appropriate board and management stance in the face of resurgent volatility will help keep the company strongly positioned for the future.

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 Russia-Ukraine war, and related sanctions.

- Does 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?

For more, see KPMG Global Economic Outlook & insights on the economy

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