RESILIENCE FOR A RAINY DAY: BOARD SPOTLIGHT ON GEOPOLITICAL ISSUES

Contents

Introduction

Businesses face a complex set of shifting considerations, and this is especially true for a board of directors when overseeing management's business strategy against the backdrop of ongoing geopolitical challenges. In executing their corporate governance, boards must consider the potential impact of these challenges and weigh them against concrete actions that can be taken.

As 2020 unfolds, the ***2019 BDO Board Survey*** reveals that weighty geopolitical forces—including a potential slowdown in the global economy, ongoing trade tensions and the war for talent—are very much on the minds of public company directors.

It's difficult to strategize against uncertainty. However, while they can't control geopolitics, directors can ensure the company prepares to respond in a way that minimizes risk. With an eye toward sustaining a company's long-term value, public company board directors can assess and balance the numerous competing priorities impacting their companies that will allow them to make crucial decisions with both responsiveness and foresight.

About the BDO Board Survey

The *2019 BDO Board Survey*, conducted by Market Measurement, Inc., an independent market research consulting firm on behalf of the Corporate Governance Practice of BDO USA, examined the opinions of 180 corporate directors of public company boards. Respondents represent a distribution of organizations across industries and market value, from less than $200M to more than $10B, who serve on a variety of board oversight committees with varying capacity and tenures.

Market Capitalization defined as:

Large/Mid Cap (Over $2B)	36%
Small Cap ($200M-$2B)	47%
Micro/Nano Cap (Under $200M)	35%

Preparing for the Unknown

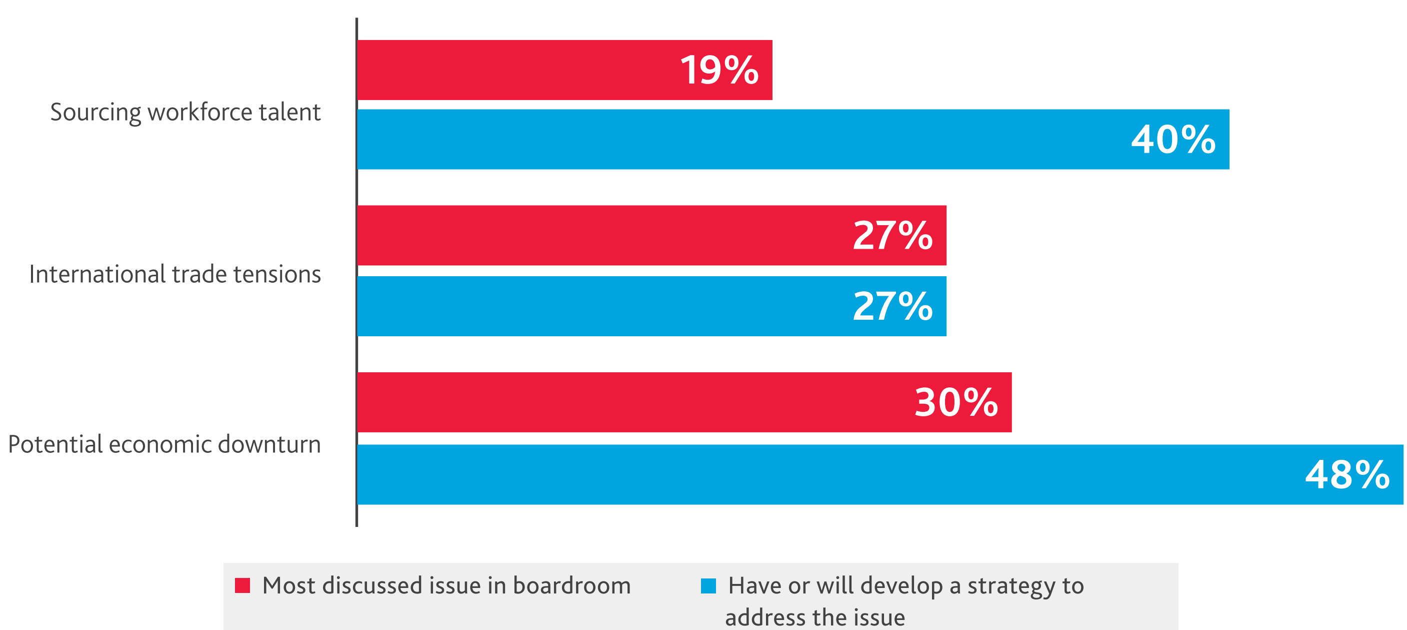
According to the *2019 BDO Board Survey*, when directors were asked which single geopolitical issue is discussed in the board room most often, three concerns stood out above all others: a potential economic downturn (30%), international trade tensions (27%) and sourcing workforce talent (19%). However, continued uncertainty around these issues has led to divergence about what specific actions to take in response.

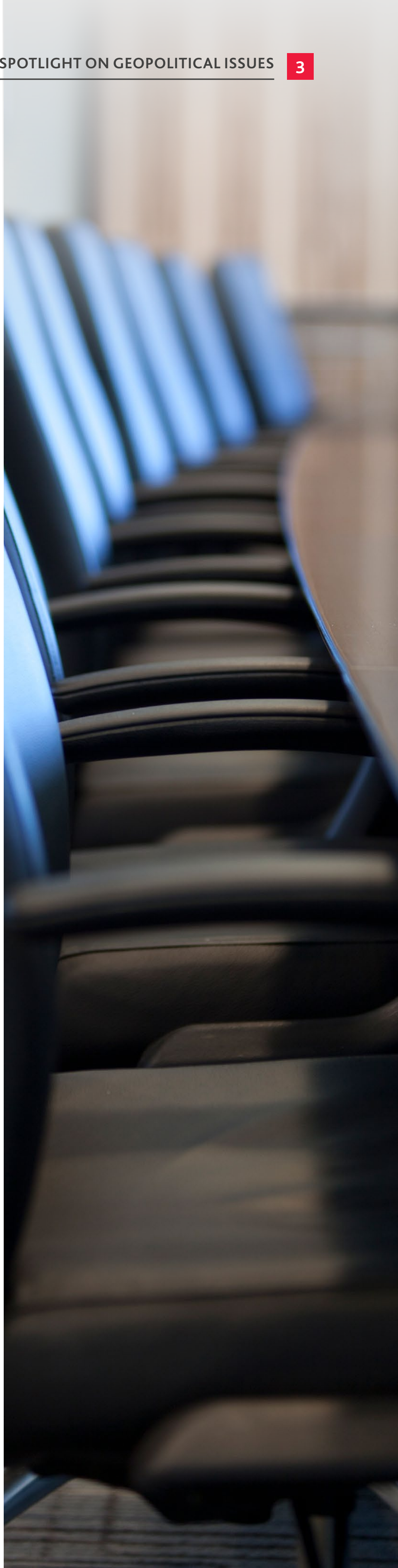
When asked which geopolitical challenges they have developed specific strategies to address, or will strategize for during the next year, just under half of directors (48%) said a potential economic downturn, while two-in-five (40%) said sourcing workforce talent and just over one-quarter (27%) answered international trade tensions. So, although boards more often discussed the complex issue of trade, they were more likely to make specific plans around how to source workforce talent.

Other significant geopolitical challenges—including the 2020 U.S. election; the outcome of Brexit negotiations; and tensions with Russia, China and North Korea, as well as ongoing developments in the Middle East—have perhaps generated less discussion and action in boardrooms. The unpredictability around these issues makes it difficult to determine how each will affect the economy going forward. It also requires unique considerations and approaches for individual companies to develop responsive strategies to address them. However, companies would be wise to scenario-plan for the likely outcomes of issues that their organization could be most impacted by and determine whether there may be opportunities to consider immediate action.

Companies appear to be currently focused on directing more attention to strategies that improve resiliency for an economic downturn, hiring and trade changes. These involve concrete steps that are within a business' control and reflect a proactive approach which can help by creating a competitive advantage. Increased preparedness for a range of market conditions has a myriad of benefit for a business. It's imperative for boards to be encouraging management to prepare for an array of eventualities and establish a response plan before a crisis occurs.

TOP ISSUES DISCUSSED IN THE BOARDROOM AND ACTION TAKEN IN RESPONSE





Boards Remain Wary of a Downturn

While the economy has enjoyed a strong period of growth, companies appear to rightly be planning for periods of slowdown so that they are ready to respond to changing market conditions. Despite record highs for stock markets and historically low U.S. unemployment figures, economic headwinds, (particularly driven by international indicators), persisted during 2019 and continue into 2020. That is why a potential economic downturn is the most-discussed issue in board rooms, and approximately half of all directors are developing specific strategies to deal with it.

GDP growth in the U.S. slowed from 3.1% during Q1 2019 to 2.1% in Q4, according to the Bureau of Economic Analysis (BEA). However, encouraging figures for manufacturing and trade led the Atlanta Fed to estimate in early March Q1 2020 growth at 2.7%, which would signal the decade-long economic expansion is poised to continue throughout 2020. It is presently unclear how uncertainties arising with respect to the widespread outbreak of Coronavirus (COVID-19) will impact the U.S. economy as companies look to assess financial ramifications stemming from massive global quarantines, travel bans, and related work slowdowns and delays.

After increasing interest rates four times during 2018, the Federal Reserve provided economic stimulus in July 2019 with the first rate cut since 2008. Overall, the Fed made three quarter-point rate cuts during 2019, which signaled a change in strategy for the central bank. Following a meeting of the Federal Open Market Committee in December, the promising post-meeting statement held that: *"The current stance of monetary policy is appropriate to support sustained expansion of economic activity [and] strong labor market conditions."* Then, on March 3, 2020, the Fed provided an additional emergency rate cut of half a percentage point to limit or ease the economic impact stemming from the Coronavirus. The SEC has also responded by issuing an order that provides publicly traded companies an additional 45 days to file certain disclosure reports outlining material risks to their business and operations and may extend this reporting relief if circumstances warrant.

Monetary policies and relatively low interest rates during the decade of record-setting growth have also coincided with increasing U.S. corporate debt, which is near $10 trillion, close to half the national GDP. That level of debt has raised flags—including from Securities and Exchange Commission chairman Jay Clayton—about businesses being overleveraged, and it would represent a significant burden in the event of a potential downturn.

As boards weigh all of the economic indicators, taking measures to reduce capital expenses and understanding exposure from and how to effectively manage debt with both vendors and customers can help provide some relief during a slowdown. And while corporate debt is a widespread issue without a quick fix, encouraging management to conduct a stress-test can also help identify areas of vulnerability while there is still time to take corrective measures.

The Impact of Tariffs

The Trump administration has taken an aggressive stance on international trade, alleging that unfair actions by China and the European Union justify the imposition of tariffs to level the playing field. Claims of China's business malpractice and industrial espionage against the U.S.—especially related to technology and biomedical research—as well as EU subsidies for aerospace giant Airbus, have provided the justification for the tariffs. However, these measures have had a cascading effect.

In January 2018, the U.S. imposed tariffs on washing machines and solar panels under Section 301 of the Trade Act of 1974. The Chinese government had placed barriers on U.S. exports of these products for years, and the tariffs were intended to remedy that, but U.S. consumers also felt the squeeze of higher prices.

Then March 2018 saw the introduction of 25% tariffs on steel and 10% on aluminum, which rippled across the globe, disrupting supply chains as numerous industries scrambled to adjust. In June, tariffs were extended to other trading partners, including the EU—which filed a challenge with the World Trade Organization, only to have that challenge struck down in October 2019 over the Airbus subsidies—as well as India, Mexico and Canada. Trade talks for the U.S.-Mexico-Canada Agreement (USMCA) eventually prompted the reversal of tariffs on those two countries in May 2019.

However, the U.S. trade actions also resulted in retaliatory tariffs imposed by China—on items ranging from liquefied natural gas to soybeans—and other nations, which further escalated tensions and significantly impacted U.S. exports. This forced the Trump administration to take measures that could mitigate the impact, such as a multibillion-dollar assistance program for farmers announced in July 2018, but these and other actions have served as more of a band-aid than a solution.

The announcement of a Phase One trade agreement in December 2019 (signed in mid-January 2020) led to the suspension of planned tariffs and a reduction of existing tariffs on a small group of consumer goods. Despite a reduction from 15% to 7.5% in Section 301 duties on another small group of products, the 25% China tariffs remain in place for the vast majority of products originating in China. While this is viewed by many as a "truce" in the ongoing trade tensions, all observers generally agree that further progress will have to await the outcome of the 2020 U.S. presidential election.

How Businesses Are Responding to Tariffs

Overall, boards have been divided about what specific tactics to use against escalating trade tensions. According to the *2019 BDO Board Survey*, the two most common actions—discussing trade tensions as a regular agenda item at board meetings (30%) and considering other countries for sourcing (29%)—were taken by less than one-third of directors, and just 19% had conducted studies about the impact of existing and proposed tariffs.

Data from BDO's ***2020 CFO Outlook Survey*** also shows how numerous industries have been directly impacted by the trade tensions. More than one in five manufacturers said they had experienced supply chain disruption in the last year due to government restrictions related to tariffs. At the same time, 40% of retail CFOs said they had raised prices on goods due to escalating trade tensions, a notable difference from the 13% of board directors who said they had raised prices. The domino effect to consumers could lead to reduced spending and impact revenues for corporations.

While the Phase One trade agreement had been highly anticipated, businesses must continue to address roadblocks and disruptions to global supply chains, particularly because the timeline for a potential Phase Two agreement likely remains on hold until after the 2020 U.S. presidential election. The *2019 BDO Board Survey* also shows that some companies have already examined domestic alternatives for supply sourcing (11%) and considered reshoring production to the U.S. (6%).

Perhaps most importantly, all businesses need to establish a comprehensive understanding of their **total tariff liability**. There are numerous practical and concrete measures that companies may take that can potentially reduce this liability, such as applying for exemptions from the Section 301 and national security tariffs, reviewing tariff codes and seeking ways to legally lower customs values. For M&A transactions, it's also vital for the acquirer to closely review the potential **impact of tariffs during due diligence**, especially regarding matters around tariff classification, customs valuation and country of origin. By having a thorough understanding of tariff liability and how management is addressing it, boards can make fully informed decisions about how to move the business forward and assess management's strategy for sustainable growth.

10 KEY QUESTIONS FOR UNDERSTANDING TOTAL TARIFF LIABILITY

1. Who oversees customs and trade planning and compliance within your organization?
2. How much does your company pay each year in global customs duties?
3. Do you maintain an internal database of each tariff code under the Harmonized System for each product that you import or export?
4. If you have related party transactions, has your company prepared an analysis under the customs rules to support the arm's length nature of the intercompany pricing for imported tangible goods?
5. If you import into the U.S., are your products subject to antidumping duties (ADD) or countervailing duties (CVD)?
6. Has your company ever been audited by CBP or subject to any prior penalties, seizures or other enforcement action?
7. Has your company ever performed an external audit of U.S. or global customs compliance?
8. Does your company have a formal free trade agreement qualification program that meets all applicable requirements?
9. Does your company import merchandise made by a contract manufacturer?
10. Does your company export merchandise in the same condition as it was in when imported or as a material used in the production of your exported good?

Read the comprehensive list of ***Top 10 Considerations for Customs Planning in 2019 and Beyond***.

Sourcing Talent in a Tight Labor Market

2019 closed with U.S. unemployment at 3.5%, the lowest level in 50 years. Because of this, companies have a historically shallow pool of job-seekers to draw from, and they face shortages of qualified workers. Other factors, including tighter border controls and regulations, have decreased talent migration as well. Furthermore, as digital literacy becomes increasingly important and appropriately skilled workers in technology and data science remain in short supply, more businesses are being forced to pursue upskilling and reskilling of their current workforce.

Faced with these challenges, companies can take several steps to develop a competitive workforce that addresses present and future needs. Human resources departments can use existing data, and even end-to-end software solutions, to more effectively identify skills gaps across the organization and plan strategically for hiring in the short term and long term. To attract employees from other countries, offering some non-salary incentives, such as relocation assistance, can have key influence. Examining the potential for internal talent mobility across projects, roles and locations, including for junior workers, can help address certain needs as well.

In terms of the demographics of prospective employees, Millennials—who happen to be the largest segment of the current workforce—and Gen Z workers have the highest concentrations of in-demand tech and data science skills. Offering benefits that appeal to these demographics can greatly aid recruiting and hiring, as well as retention. Flexible work arrangements, including remote work options, are increasingly common, and some candidates may expect these to be offered, depending on the industry. Retirement plans that allow for flexible contributions and options to make socially responsible investments also appeal to many candidates. Non-medical benefits, such as financial wellbeing and general wellness programs, as well as a range of workplace amenities, also help set an employer apart from the rest.

Alternate staffing options, including hiring part-time, short-term and on-call workers, can address specific talent needs without adding long-term obligations. Businesses today have more options for hiring contract workers and freelancers, who, with proper incentives, could even become full-time employees after demonstrating proficiency. Co-sourcing may be an option as well, which leverages in-house staff to complete certain aspects of a project and outsources specialized parts of the task. Managed services providers offer another solution and can typically cover core tasks including accounting, tax and IT support.

Faced with a tight labor market and geopolitical forces impacting talent mobility, boards should be working with management across the business in examining the range of factors that could potentially aid both recruitment and retention overall.

Rainy-Day Resiliency

Many companies share a guarded optimism as they balance the need to strategize for growth with navigating the murky path ahead. After all, uncertainty in the market can also be an opening to capitalize on business opportunities.

Businesses can take several concrete steps to prepare for a downturn and mitigate the potential effects. These include diversifying revenue streams, growing the customer base, divesting unprofitable business units, investing in digital transformation initiatives, increasing liquid capital on hand and reducing inventory.

According to BDO's ***2019 Middle Market Digital Transformation Survey***, 97% of executives said they do not plan to decrease spending on digital investments, and 79% plan to increase spending in that area. Using digital tools and initiatives to **improve efficiency** and **optimize the customer experience** can help bolster profitability regardless of economic conditions. Overall, guiding decisions with data analytics throughout the organization can increase productivity and spur growth. While it may be tempting to pull back on digital investments to help prepare for lean times, this also hamstrings a company's digital capabilities that could yield organization-wide benefits.

97%

of executives said they do not plan to decrease spending on digital investments

79%

of executives plan to increase spending in digital investments

Known Unknowns

While it is difficult to predict the specific impact that geopolitics may have on a business, public company boards must be forward-thinking about a wide range of conditions. With a proactive approach to governance, your business can plan for the future by acting now.

Understanding your total tariff liability, examining a range of hiring and retention options, and taking measures to prepare for a possible economic downturn can set your business up for profitability in any market condition. The key is to identify and deploy available resources and mitigate risk, while still maintaining focus on business strategy. Taking a comprehensive and holistic approach helps ensure success.

Learn more about how these issues and other emerging trends can affect your business at **BDO's Center for Corporate Governance and Financial Reporting**, which provides vast resources, webinars and live events.

CONTACT

DAMON V. PIKE
561-207-3205
dpike@bdo.com

AMY ROJIK
617-239-7005
arojik@bdo.com