



Understanding systemic risk in the consumer goods industry

KPMG's Dynamic
Risk Assessment



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Consumer goods companies are facing a challenging environment, with high inflation, supply chain disruption, labor shortages and other economic trends driving higher risk. Using the conventional risk assessment playbook created for more stable periods, those companies would evaluate risks along two criteria: probability and severity. Each risk is evaluated discretely, as if it were operating independently of others. But risks don't manifest discretely – they conjoin. One risk that may be assessed as low-impact on its own could trigger other risks and, together, form a high-probability, high-severity risk cluster.

As the economic landscape evolves, consumer goods companies that focus on systemic risks instead of discrete risks will have greater resilience, drive value and increase stakeholder trust. Management needs to be prepared to mitigate interconnected risks. For boards, an understanding of how risks combine provides a clearer overview of the risk landscape, which board members can use to ask strategic questions of management.

A resilient company must invest, strategically, in the top "risk emitters" – areas that affect and influence the greatest number of other risks. For the consumer goods sector, these are technology, digital, organizational agility, brand, understanding the local customer, cyber, and complacency or incumbency.



Risk in the current macroeconomic environment

Globally, we are currently experiencing a massive macroeconomic shift from a previously more stable period of globalization, democratization, deregulation and privatization. Around the world, nationalism is on the rise. Environmental, social, and governance (ESG) concerns are escalating as consumers and regulators scrutinize the impact of companies' commitments to decarbonization and diversity, equity and inclusion. The Internet age is evolving with the development of the metaverse.¹ Pre-pandemic there were no inventory levels, due to JIT supply chains. Now, absent JIT supply chains, we are observing the re-establishment of inventories, including the financing thereof - trade finance.

This shift changes the risk dynamic profoundly. In a period of tumult, the past no longer informs the future. Indeed, it misrepresents the future.

During periods of globally accepted and adopted economic convention, such as the past 40 years of globalization, risks exhibit largely cyclical behavior – even if it is profoundly volatile. This gives risk some predictability and allows organizations to model risks more precisely. But in our current environment, companies need a new playbook.

The landscape for consumer goods companies

In addition to broader macroeconomic shifts, in the consumer goods sector, high inflation, supply chain disruption, and labor shortages are both emergent and persistent challenges. In the U.S., inflation hit a 40-year high of 9.1% in June 2022.

The U.S., inflation hit a 40-year high of 9.1% in June 2022. Interest rates are increasing, but slowing consumer spending has not yet derailed inflation.² Both manufacturers and retailers are bracing for a potential recession: In a recent KPMG survey³, 88% of consumer and retail CEOs said they anticipate a recession in the next 12 months, and 41% of consumer and retail CEOs plan to take steps to diversify their supply chain in the next six months. For management, managing and mitigating risk is becoming exponentially more challenging.



¹ KPMG LLP, "Beyond gaming: the real metaverse opportunity," September 8, 2022, <https://info.kpmg.us/news-perspectives/technology-innovation/kpmg-survey-metaverse-opportunity.html>

² KPMG LLP, "KPMG 2022 Inflation Survey," 2022, <https://advisory.kpmg.us/insights/inflation-resilience.html>

³ KPMG LLP, "Economic outlook," August 2022, <https://home.kpmg/xx/en/home/insights/2022/08/kpmg-2022-ceo-outlook/economic-outlook.html>

Assessing risk as the economy shifts

The risks facing consumer goods companies do not manifest in isolation. On the contrary, they combine to form what many would call a perfect storm. They need to be modeled in combination, as they exhibit in real life. KPMG undertook risk modelling for the consumer goods sector on

this basis, using an established methodology, Dynamic Risk Assessment. It revealed that, in traditional risk modeling, the most probable discrete risks are input cost or inflation risk, talent, and cybersecurity.

Severity and likelihood



Evaluating the risks for discrete severity, cybersecurity comes out on top, followed by geopolitical forces and complacency or incumbency. A company could try to mitigate each risk discretely, but that would be to try to win each battle, as opposed to the bigger war. Instead, companies must focus on risk emitters. For the consumer goods sector, the top risk emitters are technology, digital, organizational agility, brand, understanding the local customer, cyber, and complacency.

Acknowledging that one risk can trigger another, our assessment painted a new picture: Looking through the lens of non-discrete risk clusters, we identified two clusters for the sector: strategic and operational. The strategic cluster includes cyber; digital; technology; organizational agility; decentralized automated organizations (DAOs); building, sustaining, and advancing the brand; and understanding the local customer. The operational cluster comprises currency volatility, input cost/inflation risk, and price inelasticity.

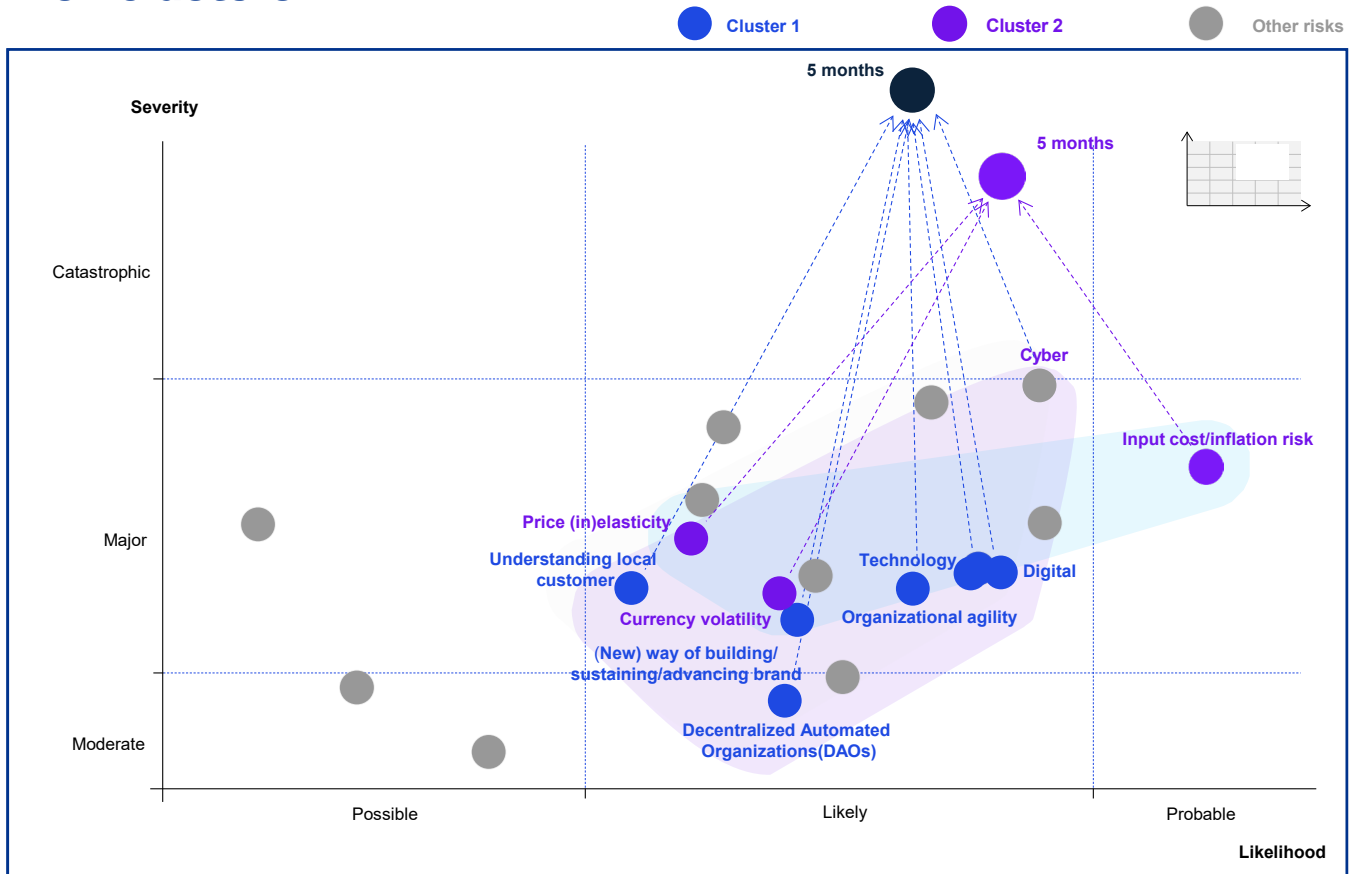


If any individual risk in either of these two clusters is triggered, it will spread to the others to produce an aggregate risk. They are therefore expected to present almost simultaneously, with the aggregate severity surpassing the most

severe individual risk. Most of the risks that form the two clusters would not have been identified as high-threat risks using traditional Enterprise Risk Management, as their propensity to trigger other risks would have remained unassessed.



Risk clusters



Interpreting the operation of the wider network, including the clusters identified, we are able to identify long-term systemic risks that could impact companies in the sector’s future performance. These pose the most severe, systemic longer-term performance impediments to the sector.

For the sector, the top long-term systemic risk is technology, followed by companies’ ability to adjust – rapidly – to the changing circumstances and, thirdly, their ability to capitalize on digital developments. All the other risks identified are linked, directly or indirectly, to these risks, rendering the industry predisposed to them in terms of overall longer-term vulnerability. They also represent the industry’s safeguards to future performance and sustained shareholder value:

focusing investment on technology and digital transformation, as well as supporting innovation rather than complacency or incumbency, are the key ingredients for future sustained performance.

Companies can’t see the future, but by understanding the interplay and interconnectivity of risks combined with the economic environment, consumer goods companies can prepare. Attacking individual risks as they arise will not protect a company in times of economic upheaval. Consumer goods companies that evaluate systemic risk by recognizing how risks interconnect will be better-positioned in the years to come, increasing stakeholder trust and organizational resilience.

What is Dynamic Risk Assessment?

Dynamic Risk Assessment is a patented methodology developed by KPMG to help bring a deeper understanding of the risks organizations face in today's changing, complex world. Combining qualitative and quantitative data, Dynamic Risk Assessment takes a differentiated approach to gaining insights into clients' risk environments by addressing risks' propensity to interconnect with each other, making explicit allowance for structural breaks (future game changers), and acknowledging that the unfolding shift from globalization to deglobalization will result in future risk behaviors departing radically from those of the past four decades. In so doing, Dynamic Risk Assessment pinpoints central risks and sheds new light on future risk mitigation strategies. This Dynamic Risk Assessment for the consumer goods industry incorporates insights and input from approximately 20 senior KPMG consumer industry partners around the world.

The value of seeing around the corner

A more dynamic view of risk is akin to being able to look around the corner. Like many industries, a lack of talent is an existential threat to the consumer goods sector. Within the context of a dynamic risk assessment, talent becomes, in many ways, a domino in a series of risks to the industry: Without talent, it's harder to understand the customer. Without understanding the local customer, it's challenging to build / sustain a strong brand. Without a strong brand, it's harder to build a cutting-edge digital team with partnerships. Without digital prowess, it's harder to be agile. Mitigating talent risk is the key to managing these downstream risks.

It is vital to obtain an informed understanding of future, even unprecedented, risks. After all, these risks will unfold to eventually impact valuations, results, and disclosures in the financial statements.

Board and audit committee lens

While risk assessment and strategy are the responsibility of management, we see boards and audit committees in the consumer goods sector continuing to intensify their oversight and engagement on risk. Beyond focusing on – and being prepared to respond to – discrete risks, how is management monitoring and mitigating the most influential systemic risks? In particular, boards and audit committees in consumer goods are sharpening their focus on the confluence and complexities posed by risks in several key areas:

Cyber security and digitization: Audit committees should stay attuned to organizations' approach to managing cyber and data governance risks – particularly in light of the convergence of data and tech risks: Is the company taking a holistic approach? Key areas of focus include access controls (both internal and by third-party vendors), as well as management's disclosure controls and procedures for cyber breaches, according to a 2023 KPMG Board Leadership Center report⁴.

Geopolitics: Additionally, boards and audit committees in the consumer goods sector are increasing their focus on geopolitical risks⁵, including the effects on emerging market growth and global gross domestic product, as well as the dominance of big tech and the related data protection and consumer privacy risks.

Talent: The "Great Resignation" is also a risk management concern, with the war for talent⁶ potentially affecting financial reporting risk and controls. Audit committees should ask management how the organization is ensuring its finance department has appropriate staffing to meet financial reporting and compliance needs, and to keep pace with evolving technologies.

⁴ KPMG Board Leadership Center, "On the 2023 board agenda," December 14, 2022, <https://boardleadership.kpmg.us/series/on-the-agenda.html>

⁵ KPMG Board Leadership Center, "Eurasia Group's top geopolitical risks for 2022," 2022, <https://boardleadership.kpmg.us/relevant-topics/articles/2022/eurasia-groups-top-geopolitical-risks-for-2022.html>

⁶ KPMG Board Leadership Center, "When talent risk poses financial reporting risk," 2022, <https://boardleadership.kpmg.us/relevant-topics/articles/2022/when-talent-risk-poses-financial-reporting-risk.html>



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