

The Association of Corporate Treasurers

Briefing note:

Contingency planning for a downturn in the economy:

A treasurer's checklist

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TREASURY, RISK
AND FINANCE
PROFESSIONALS

ACT

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The Association of Corporate Treasurers

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The ACT defines and promotes best practice in treasury and makes representations to government, regulators and standard setters.

We are also the world's leading examining body for treasury, providing benchmark qualifications and continuing development through education, training, conferences, and publications, including *The Treasurer* magazine.

Our 3,500 members work widely in companies of all sizes through industry, commerce and professional service firms.

For further information visit www.treasurers.org).

Guidelines about our approach to policy and technical matters are available at <http://www.treasurers.org/technical/resources/manifestoMay2007.pdf>.

This briefing note was drafted by The ACT's Policy and Technical Department (e-mail: technical@treasurers.org) and commented on by members of the Policy and Technical Committee, to whom thanks are due.

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Contingency planning for a downturn in the economy: A treasurer's checklist

Introduction

This briefing note is intended to aid the treasurer in thinking about and planning for a downturn in the economy or sustained lack of liquidity in financial markets and the effects on his company

Even if your industry and company are in good shape, you will still want to review these notes when considering how your customers, suppliers, competitors and potential acquisition targets may be affected and how they may respond. The Briefing includes many points which might be considered good housekeeping in any circumstances.

Some general points can be made.

First, businesses generally fail because problems are noticed too late... Thinking about vulnerabilities and opportunities early on can be a big advantage. A few key people in the company should be contingency planning for the downturn and the treasurer needs to be part of that group. Remember however that contingency plans provide a basis for action but will require adapting to actual events and opportunities – not necessarily precisely what you planned for.

Second, the treasurer needs to understand the firm and the industry. Find and talk to people in the firm who have experience of previous downturns – the last one in Europe was in the early 1990s, following the Gulf War. If all your colleagues developed their professional skills during recent periods of growth, maybe you can go and see retired CEOs, FDs, divisional MDs. Perhaps there have been academic studies of your industry/firm in a downturn or recession. What did the companies that emerged in best shape from the downturn do? And remember that history does not precisely repeat itself.

Third, if things do start to go wrong, to whom will you turn for help and support? Keep your contacts list with you at all times (and leave a back-up at the office).

“Treasury”?

“The Treasurer”?

The treasurer should be concerned with financial strategy, financial policy and risk management among other ways to support the business. The Finance Director and the Chief Executive would, rightly, say the same about themselves. Who actually does the treasurer's job varies from company to company, and not all of the job will be done by someone with the job title “Treasurer”.

So how the treasurer follows up the points in this Briefing Note will similarly vary.

Of course a company's position going into a downturn will be highly contingent on its industry and history. Was the firm recently subject to a highly levered management buy-out, or has it a cash pile from selling a division deemed non-strategic, for example? But the treasurer should be a key player in either case.

If there may be a downturn, treasurers, as usual, have the opportunity to show either that they are ready for promotion or are more of back-office people to be kept in their place.

Things to consider and to talk to your colleagues about:

- **Treasury basics**
- **Credit rating**
- **“Going concern” and disclosures in a downturn**
- **Making best use of available bank credit**
- **Getting the balance sheet in shape**
- **The business**
- **Reorganising the deck-chairs**
- **Treasury staffing**

Your colleagues will probably already have thought, at some level, about the points in this Briefing Note too. Respecting their professional knowledge and business experience, (without abdicating your own responsibility) is usually an important part of being effective.

If you are other than very confident, consider getting advice also from a specialist in company recovery. They will have seen many occasions when companies have made matters worse in the year or two before major problems - made recovery much more difficult or even impossible in ways which could, with thought, have been avoided. Legal advice may also be necessary.

Treasury basics

Cash

The old saw is that 'Cash is King'. This can be very true in that a balance sheet with ample assets in the long run does not protect your company from disaster if liquidity runs out. In any downturn:

- Cash (equals survival) may need to take precedent over profit if there is a conflict (but beware traps such as interest or fixed charge cover covenants)
- it is even more important to ensure there are no pockets of idle cash around the group
- liquidity becomes critical – ensure no “draw-stops” in loan agreements can operate to deny access to needed credit lines

- understand current supplier and customer terms and where there may be opportunity to flex them
- if paying taxes quarterly based on estimates of profits remember to adjust payment if forecasts are changed
- See “The business”, below

Risk management

- There may be more volatility of exchange rates, interest rates and commodity prices at a time when ability to pass on cost increases to customers is more limited. Fluctuations may also affect, for example, ratio covenant compliance (be alert to adverse combinations such as use of average exchange rates for profit and loss items and point in time exchange rates for balance sheet items putting ratios into breach).
- Credit risks become very important – not just in relation to trade debtors but to business and financial counterparties of all kinds. (See Counterparty risk, below)

Credit rating (or proxy for that)

The key to availability of funding is often the relative stability of credit rating/standing during any downturn. Companies perceived as more likely to suffer during a downturn may find more problems even before they actually start so to suffer. If the company’s credit rating was significantly affected during the last/a past downturn, come up early with good reasons why it may be different this time and communicate early with lenders (and other investors). It will probably be hard to interest new lenders at this stage of the cycle.

Going concern and disclosures in a downturn

In order for the Board and the auditors to sign off the accounts on a going concern basis, they will need visibility of the financing of the company for a year to eighteen months ahead and a good view of the business plans generally.

The UK’s Financial Reporting Council issued in December 2008 two papers covering the various requirements for companies in considering necessary disclosures related to the current economic downturn, and whether accounts can be published on a going concern basis (perhaps with extended wording drawing particular attention to certain matters) or not. The general state of the business and its cash flows are important here but also the availability of finance. The FRC guidance recognises that under current financial market conditions it is not always possible to get confirmation from banks that finance will continue to be available for the ‘foreseeable future’, but that this does not automatically mean that accounts cannot be prepared on a going concern basis.

Treasurers should be well prepared and have a major input into discussions with the Board, audit committee and auditors in respect of cash flow forecasts and the availability of finance and any required disclosures.

The FRC press release is available from www.frc.org.uk/press/pub1781.html, and the two relevant papers, Challenges for Audit Committees arising from current economic

conditions and An Update for Directors of Listed Companies: Going Concern and Liquidity Risk are accessible from that page.

Also in December 2008, the Auditing Practices Board issued guidance on the same topic to auditors and treasurers will find it useful to be familiar with that guidance. The APB guidance is available at <http://www.frc.org.uk/apb/publications/pub1824.html>.

Treasurers should check loan and bond covenants, and requirements for representations and warranties to ensure that any extended audit report will not precipitate problems.

Making best use of available bank credit

Banks will have formed a view of the maximum credit exposure they are willing to take on your company. You need to ensure, by dialogue with the banks, that you are making best use of that.

Commonly, companies will want direct credit (loans and overdrafts) and credit equivalent exposures too. It is important regularly to go through with banks all uses of credit they mark for you. It is not uncommon to find substantial amounts marked against activities which ceased long ago and which can be released for current productive use.

- Are overdrafts and lines of credit marked by the bank all required?
 - Amounts marked for branches or subsidiaries closed or sold
 - Particular facilities no longer required
 - Lines for foreign activities which could be released if local banks were used locally
- Issuing of bonds and guarantees
 - Do you need the line?
 - Are there outstanding bonds or guarantees which the beneficiaries should release and return as the underlying obligation or contingent obligation has been satisfied?
 - If a bond or guarantee cannot be released by the beneficiary (foreign governments and local governments can be notorious for this), is insurance of the bond or guarantee available to permit release of some or all of the blocked credit from your bank?
- Transactional facilities – credit, for example, to allow money to move smoothly, so needing intra-day (“daylight”) credit
 - Is too much allocated, or sums allocated for units which no longer deal?
- Recourse items – bill discounting arrangements etc.
 - Needed?
- Counterparty credit for foreign exchange and other derivative trading including mark to market and settlement risks
 - Is too much allocated, or allocated inappropriately?

Getting the balance sheet in shape

Liabilities

- Do you know who your lenders are?
 - Are members of loan syndicates still holding the debt or have they transferred or sub-participated?
 - Even if they have not, are they protected, e.g. by credit derivatives, and just waiting for you to default in a recognised way so they can claim?
 - Who is holding your bonds?
- Does your current financing include any potential pitfalls? In particular are any dangers and covenant breaches revealed from your stress testing of the business plans.
 - “Draw stops”, e.g. need to repeat warranties on a drawing or roll-over of revolving credit lines or a “material adverse change” clause, which could prevent you drawing otherwise committed credit lines
 - Covenants etc. which might be triggered by downturn-inspired changes in accounting ratios or changes in exchange rates
 - Restrictions which might affect the company’s response to downturn – for example restrictions on disposals or uses of alternative financing, etc.
 - Automatic repayments required by changes in your credit ratings (these are very dangerous and credit lines involving such provisions should be replaced even at extra costs).
 - “Cash sweeps”
 - An MAC (material adverse change) clause

What can you do to obtain relief while it is less urgent than it might be later?

- Start early
 - Ensure you have good forecasts, looking sufficiently far ahead, about the business as a whole and not of the character that means that senior management hears what it wants to hear and junior management keep senior management off their backs for a bit longer.
 - Make sure you have to hand any/all information lenders may ask you for and keep it up to date.
- Renegotiate the clauses?
- Seek waivers
 - beware “cross acceleration” or “cross default” to, or impact on ability to repeat representations and warranties in, other debt (it is usually better to renegotiate the clauses well before there is any question of needing a waiver).

- Repay the indebtedness?
- Replace the affected stand-by lines, if possible, even at extra cost?

If a temporary draw stop seems to be coming up

- consider a full drawdown for the maximum period now or soon – even if cash has to be re-deposited
 - but remember
 - you may need to repeat representations and warranties on a drawing
 - lenders may be monitoring your usage and if the drawing is unexpected may raise questions with you
 - directors' duties – and not drawing down debt which you know or have reason to believe cannot be repaid.
- Are you reliant on rolling over short-term finance (as opposed to revolving credits)? If you did not fill your boots when medium/long-term finance was available at low cost and with minimal conditions (or even if you did):
 - should you be thinking now about raising more medium and long-term finance
 - or putting in place medium term, committed, standby lines of credit
 - beware of delaying funding in the hope of better conditions or that something will turn up – conditions may actually get worse.
- Do not assume you can roll over expiring loan facilities.
 - Talk to lenders now about maturities due in the next couple of years. Do not rely on the banks "feeling better" before you need the new facilities.
 - Expect to pay higher margins on new facilities
 - If you have kept banks in your facilities by hinting at access to ancillary business they have never won, don't expect a warm welcome.
 - Expect a frosty response from existing lenders if you move ancillary business away from them to "reward" new lenders or retain second-tier lenders.
- Should you be looking at un-conventional sources of finance, for example sovereign wealth funds or private equity
 - not just for immediate finance but also
 - possibly as potential partners if a downturn throws up acquisition opportunities among your competitors, customers, or suppliers or in adjacent fields?
- Should you be getting your shareholders used to the ideas that in a down-turn
 - it might be prudent for companies to cut dividends
 - there might be opportunities which justify a right issue

- and then do it earlier rather than later
- Don't forget to keep lenders informed and supportive – you may need their forbearance or even more of their money
 - Act early, while you are still dealing with the relationship team at your bankers - before you are deleted from their list of target customers or a bank switches you to the recovery team.
Recovery teams are about recovering the *banks'* position, not yours. In a severe downturn they are very busy: they may be able to give you 45 minutes tomorrow evening between 6.15 and 7 at their shop – when you and your CEO etc. as appropriate must make yourselves available, fully briefed and able to cover the required ground in the available time, and prepared to hang around indefinitely as the bankers are running late.
- If things really do look bad
 - Consider a major (debt, equity, etc.) restructuring earlier rather than later.
 - Take advice – both legal and from an insolvency practitioner – usually, in the first instance, a specialist accountant.

Assets

- Working capital
 - Remember that reduced procurement prices mean smaller working capital as well as lower costs
 - Can you speed up the working capital cycle to release cash while still operating ethically? Retrospective changes to credit terms taken or given would not be good practice.
 - If sales fall in a downturn how fast can you respond so as to avoid excess stocks?
 - Are you optimising creditors?
 - Can you take longer credit cost effectively?
 - Remember that if you have a better credit standing than your supplier there might be a saving by agreeing to pay earlier or to confirm the debt to the creditor's bank to facilitate invoice discounting by the supplier
 - Is there a crucial supplier which would cause you disruption if it failed, or if it were acquired by your competitor?
 - If your suppliers use credit insurance on credit granted to you, as credit insurers have limited balance sheets, cover could be withdrawn at short notice in a downturn and almost irrespective of your credit standing. Credit insurers may seek information from your company. This can give rise to dilemmas:
 - You would certainly require them to give a confidentiality undertaking, both for commercial reasons and, if you re a listed

company, disclosure rules. If you give information which might make the insurer an insider, you should notify them in advance and ask them to confirm that they have policies and procedures in place to ensure that their own staff and directors do not breach regulations affecting persons in possession of inside information or (UK only) relevant information not generally available in relation to any relevant security.

- If the information you give (or a refusal to give information) causes the insurer to withdraw credit cover, this is likely to become public knowledge and can encourage others to withdraw credit, precipitating sharp increases in working capital to be financed in some other way.
 - If a withdrawal of cover is more to do with the insurer's problems than your company's, consider the possibility of support to creditors referred to above.
 - On the other hand, if you are in that position, keep in mind disclosure requirements for listed companies nearing financial distress and take appropriate legal advice.
- Review customers for credit standing
 - And tighten up credit terms and collections (but see next below)
 - If you use credit insurance, remember that as credit insurers have limited balance sheets, cover could be withdrawn at short notice in a downturn and almost irrespective of your client's credit standing.

Counterparty risk

Think about your risks should a financial counterparty fail

- Ensure arrangements for surplus funds are prudent and diversified
- Remind yourself about termination provisions and processes in bank, swap, etc. agreements.
- Consider requesting credit support agreements or taking collateral from other than undoubted counterparties.
- Think about the extent to which your offset arrangements on your cash pooling would stand up in the event of a bank insolvency. Moving to a zero balancing arrangement may be safer than notional offsetting.

The business – there is much for discussion with your colleagues

Business practices

- If your company is sufficiently strong, there can be commercial advantage from supporting suppliers and customers.
 - But if you do this in a way which increases your credit risk, consider seeking benefits/protections which a financial creditor would ask for.

Business Plans

- Operational and financial flexibility become much more important in a downturn
- Different parts of a business, sectoral or geographic, may be subject to the effects of a downturn at different times (leaders, coincident or laggards?). Don't try to impose a one size fits all policy. Ensure that opportunities are not left on the table elsewhere because of reaction to a crisis in one important segment.
- Review plans with a newly critical eye
 - Use standard tools to clarify issues
 - SWOT (strengths, weaknesses, opportunities and threats)
 - Porter (Michael Porter's five forces of competitive position)
 - PEST (political, economic, social and technological factors)
 - etc.

If you are not familiar with these ideas read up on them now as they will probably come up frequently in discussions with colleagues and, potentially, with lenders.

- In a downturn the company is likely to be less able to withstand events it previously could just absorb
 - Update the risk register, or equivalent
 - Update risk management practices and
 - Review which risks the company is retaining/managing and consider laying off/avoiding/hedging etc. more than when the company was stronger.

Run business plan scenarios to test the outcomes under various extreme stress conditions or combinations of stresses and consider courses of action available under those scenarios. Perform reverse stress testing to understand the circumstances which could cause a breach of covenant.

- Business plans relying on funding from
 - retained earnings or
 - significant disposals
 may be vulnerable in a downturn
- Are proposed new investments still appropriate? Are they essential or merely desirable?
 - Consider cancelling, reducing scale of investment, postponing, or implementing in phases
 - Subject proposals to more critical review and prioritise carefully
 - Capacity increases? Will you need it now? New capacity added to an industry increases competition, possibly driving down prices even more than the downturn already has – can you handle that?

- Efficiency-based investments? Increasing efficiency may be key to surviving a downturn. But expected efficiencies may not be realised if, for example, sales are declining or increased product customisation to secure sales becomes necessary.
 - Will you be subject to new competitors coming into your markets in response to declines in their existing markets
 - Can the company improve its actual or prospective competitive position before they start?
 - Are there contingency plans if they do start?
 - More firms are using e-auctions for procurement and making significant savings – can you respond if your customers use these techniques?
- **Opportunities**
 - Do you know in advance which of your competitors are most vulnerable to downturns and which may withdraw from (some) markets?
 - Can you take advantage of that before other competitors take up the slack?
 - Do you need to be ready to buy opportunistically or defensively, e.g. to stop them falling into the hands of a competitor:
 - Vulnerable competitors (which may be parts of bigger firms with their own problems and keen to dispose of non-core activities or just to raise money)
 - essential suppliers or
 - key customers if you don't sell direct?
 - Might there be new opportunities to acquire businesses in adjacent fields

Avoid **Reorganising the deck-chairs** on the Titanic

You need to avoid time-wasting distractions which can use up your time and the goodwill of others inside and outside the company.

Creditors generally are watchful for companies making “last throws of the dice” and thus simply weakening the protection of lenders. Running down working capital (as opposed to managing it more efficiently), selling off crown jewels (whether businesses or key assets) and so on, with little chance of ultimate success in turning the company around before severe financial distress.

Finally: **treasury staffing**

- Consider retaining maximum staffing flexibility
 - Use temps/contractors/interim executives rather than filling vacancies with permanent hires?

- Beware of risk in using temporary staff in positions authorised to deal or to move funds
 - Perhaps reliable systems, straight through processing etc. can mean you can avoid filling the vacancy on a permanent basis.
- Some outsourcing may introduce efficiency savings and *may* aid flexibility
 - Don't outsource decision making functions
 - but do take *advice* from accountancy firms or turn-around boutiques who can provide a lot of support at critical times.
 - maybe insource key dedicated expertise. Everything in this note is about your career planning.
- You need to associated with excellent financial strategy, policies and planning in support of the business
- If you are not taking the initiative on these matters in your firm, who is?
- Check out coverage of your company's Directors and Officers liability policy and ensure that
 - it fully covers you
 - it survives for past matters even post some sort of reconstruction or insolvency
- If you are a director of any company within the group
 - ensure that there are mechanisms in place to ensure that the company is not trading while insolvent or undertaking liabilities which it has no prospect of repaying
 - if need be ask for and obtain sufficiently strong comfort from the parent company
 - ensure that the company does not extend credit etc. to any group member (or third parties) which have no prospect of repaying
 - take appropriate legal advice in case of doubt.
- And just in case, keep your CV up to date and make sure you are better known around the industry.

People

A downturn in the economy and the pressures it brings on your company can also bring pressures to bear on individuals in the company. Look out for the signs of stress within your staff and colleagues at all levels of seniority.

Be aware of behaviour changes and of any imbalance developing in the work /home lifestyle. Excessive hours, drink and drugs, or strained relationships are all danger signals.

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