

Board Perspectives: Risk Oversight

Preparing the Organization for an Economic Downturn

There is no better time to prepare for an economic downturn than when times are good. With the memory of the severity of the 2007-2008 financial crisis still fresh in the minds of many directors and executives, how should companies prepare for a downturn in the cool of the day, rather than reacting in crisis mode?

At this time, an economic downturn is not anticipated by most established business plans. However, as the last downturn had severe consequences for many organizations, a contingency plan makes good business sense because it positions companies to act decisively when recessionary storm clouds loom on the horizon.

Contingency plans are certainly not new. Organizations develop contingency plans to address market opportunities should they arise and document specific action steps that are triggered if certain events occur. Such events might include natural disasters (e.g., floods, earthquakes), cybersecurity breaches, terrorist attacks, fire, fraud, theft or embezzlement. These perils may never occur, but the plan nonetheless stands ready with a response team organized to implement it.

The focus of this discussion is how to prepare for an economic recession that causes revenues to decline below a predefined threshold.

It is virtually irrefutable that a recession will occur at some point as our historically reliable economic cycle unfolds. Therein lies the wisdom of creating a contingency plan to (a) mitigate the financial impact of a severe economic downturn on earnings and share price, and (b) position the company to gain market share during the recovery.

Below we discuss how such a plan is developed to accomplish these two objectives and the board's role in that process.

Key Considerations

The inevitability of economic downturns makes them one of the more significant risks faced by capital-intensive, highly leveraged organizations. The stark reality is that a severe recession affects everyone. No company is exempt. Like most contingencies, the timing for a significant slowdown of business activity is difficult to predict.

There are many stories — too numerous to count — of companies that were ill-prepared for an economic downturn and, as a result, either suffered severe damage or went bankrupt. Suffice it to say that the threat is real to seasoned executives and boards. Therefore, creating a contingency plan is a practical risk management strategy for any CEO and his or her board.

A credible plan also protects executives and directors against lawsuits for failure to exercise due care. In fact, in the United States, the largest, most complex banking organizations supervised by the Federal Reserve are required to file resolution plans annually to set forth the institution's strategy for rapid and orderly resolution in the event of material financial distress or failure.

Our view is that the best time to prepare for a downturn is when a company is operating in a healthy, stable economic climate — not while it is in distress. Creating a plan in a thoughtful, deliberate manner helps ensure the plan is supported by detailed analyses, adequately considers sequential actions and seasonality, maximizes the options available to decision-makers, and addresses considerations relating to contractual obligations, employee and union issues, and regulatory compliance.

In preparing a contingency plan, action steps are sequenced, prioritized and grouped by corporate function and operating unit so that ownership of, and authorities for executing, each step are clear. Targeted cost savings in the current and subsequent projection year(s) should also accompany each action step. The key elements of a plan for most companies are discussed below.

- **Headcount and hiring changes** — Human capital is commonly one of a company's largest and most controllable expenses. Management must carefully evaluate the cost-benefit of its investment in human capital in a distressed environment. It is a time for shepherding the talent most critical to retain. Focused retention, objectively determined workforce reductions and changing hiring practices are often important components of a contingency plan.
- **Compensation, benefits and incentive plan adjustments** — Temporary revisions to compensation, benefits and incentive plans may be necessary to stabilize the firm's financial condition. Vetting the economic realities of a declining top line and the need for adjustments to the reward system with key personnel before a downturn creates a broader support base for the plan when it is implemented.
- **Asset divestitures** — Capital-intensive and diverse companies may have underperforming assets or divisions that can be sold to stave off losses, reduce debt, and generate liquidity and working capital. Alternatively, there may be high-performing, nonstrategic assets that can be sold to raise capital.

In developing the contingency plan, management should categorize the company's assets — underperforming versus high-performing, strategic versus nonstrategic — so that a plan can be developed for each asset category. The plan should consider the timing and the immediate and long-term financial impact of asset sales, and the need for such sales as signs of extreme economic scenarios appear. Timing can be a critical factor as it makes little sense to sell assets once the market is depressed. It may also be possible to enter into sale-leaseback transactions for certain facilities to raise capital while retaining use of the assets.
- **Selling, general and administrative (SG&A) expense cutbacks** — SG&A offers many opportunities to reduce costs. In the context of a contingency plan, the objective is to adjust the cost structure to support stabilization and preservation of the enterprise.
- **Consider other options** — There are other steps a company can take before an economic downturn to protect against its impact. For example, management can hedge raw material costs and lock in sales prices, and thereby stabilize margins — at least for a time. Also, if it will reduce costs, management can consider outsourcing noncore activities that are not strategic to the business (e.g., certain human resources support, accounting, manufacturing and transportation activities). As for marketing and branding, viewing market-facing expenditures as a pure cost can lead to deep cuts that can undermine the strategy. It may make more sense to

focus marketing on sustaining brand awareness during the recession. Finally, the contingency plan should address the impact of interconnectivity, both upstream and downstream within the value chain. For example, what steps would the company take if a major supplier were to go under due to the downturn?

- **Hierarchy for cost-savings initiatives** — The plan should outline a comprehensive menu of cost-savings initiatives that could be implemented in the event of a downturn. Each initiative should be prioritized to create a scalable plan. Depending on the severity of the downturn, some or all of the initiatives can be implemented. Initiatives might include reductions in headcount, marketing spend, expansion initiatives, consulting fees, bonus and benefit programs, community support, charitable giving, and auto allowances. They also might include discontinuing underperforming operations.
- **Communications plan** — In times of economic uncertainty, people like to be informed. To that end, timely and open communications are vital to preserving morale in tough times so that employees know where they stand and how they and the organization can get through the crisis. Straight talk and transparency are important because, from an employee perspective, no news does not necessarily mean good news.

An effective plan should determine the key metrics to be managed against the enterprise's specified targets, such as net operating income percentage, gross margin percentage, acceptable variance from budget, earnings per share, minimum cash reserves and maximum debt levels. With targets identified, a financial forecast over an appropriate period should be prepared to establish a baseline. Considering different scenarios — revenue declines of, say, 10 and 20 percent — the costs and expected benefits from the various elements mentioned above should be considered to ascertain specific actions management should take under the circumstances.

Once completed, the plan should be reviewed with and approved by the board. The company then resumes its growth strategy with full knowledge that the contingency plan is ready when the time comes — and, unfortunately, it *will* come. A vetted, actionable contingency plan saves precious time during a crisis. When appropriate members of the management team are involved in the plan's development and ratification, there is a broader base of support for its execution. Preparedness leads to decisiveness under fire.

Management should review the plan on a regular basis — say, annually — to ensure it remains current and apprise the board of any significant changes made to the plan. Going forward, management should monitor the external and internal economic indicators appropriate to the company, and periodically review the analysis with the board.

Triggering the implementation of the contingency plan is a matter of choosing the right time. That decision may be a challenging one to make. But even if the optimal timing is missed, having a plan in place is better than having no plan at all.

Once the plan is initiated, a project management office (PMO) should be designated to drive its implementation. The PMO monitors the achievement of the assigned initiatives and provides status reports to senior executives and the board. The broad support base for the plan, as discussed above, makes the PMO's job easier.

Given the inevitability of recessions, it would be prudent for boards of directors to insist on developing a response plan under sunny skies rather than when the recessionary storm breaks. Such action on the part of the board would demonstrate due care and sound business judgment in discharging its oversight responsibilities to address a credible threat. Further, entering a distressed operating environment without a thoughtful, comprehensive plan can lead to hasty decisions, inefficiencies and costly delays. The organization's stakeholders deserve better.

Questions for Boards

Following are some suggested questions that boards of directors may consider, based on the risks inherent in the entity's operations:

- Is the board satisfied that management has a proactive contingency plan in the event of an economic downturn? Have directors reviewed and approved the plan? Is the plan updated periodically?
- Does management monitor the appropriate economic indicators and their implications to the execution of the growth strategy and brief the board on the insights gained?

How Protiviti Can Help

Protiviti's business, risk management and restructuring consultants help clients prepare for and manage all forms of risk, including the risk that dramatic changes in the economy or in a particular industry could have a devastating impact on a company's revenues. Business failures often accompany severe economic downturns. Protiviti positions firms to both weather the storm and benefit from a market recovery through a lean infrastructure and improved market share.

Is It Time for Your Board to Evaluate Its Risk Oversight Process?

The TBI Protiviti Board Risk Oversight Meter™ provides boards with an opportunity to refresh their risk oversight process to ensure it's focused sharply on the opportunities and risks that truly matter. Protiviti's commitment to facilitating continuous process improvement to enable companies to confidently face the future is why we collaborated with The Board Institute, Inc. (TBI) to offer the director community a flexible, cost-effective tool that assists boards in their periodic self-evaluation of the board's risk oversight and mirrors the way many directors prefer to conduct self-evaluations. Boards interested in using this evaluation tool should visit the TBI website at <http://theboardinstitute.com/board-risk-meter/>.

Learn more at
www.protiviti.com/boardriskoversightmeter

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