Top considerations for CFOs to build an effective COVID-19 finance response strategy

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Abstract

It's clear that the US economy, along with other economies around the world, has come to a halt—with some industry sectors experiencing greater impact than others. For example, TCS research around current marketplace dynamics show that industries like travel, transportation and hospitality have been heavily impacted. By comparison, the utilities sector has been moderately impacted and biotech (including medical devices) firms have been mildly disrupted. Many CFOs will be tempted to take quick, reactive cost-cutting measures, but finance leaders should also consider implementing a strategy designed to manage short- and medium-term business impacts from COVID-19 as well as planning for longer term market recovery.

Taking Stock of Business and Financial Risk

CFOs are expecting the COVID-19 pandemic to continue hitting them where it hurts most: their top and bottom lines. Mandatory closures of nonessential businesses, schools and the cancellation of large public events have created a significant shift in the typical supply and demand equation, causing a Gross Domestic Product (GDP) tailspin. Voluntary actions like working from home and restrictions around retail shopping and travel have further put the brakes on the economic machinery. These public safety mandates are creating significant challenges for CFOs who are not only looking for short-term cash preservation measures, but also trying to understand their supply chain risk and proactively manage a business reboot in the near future.

The US, Europe and UK Economic Outlook

The trajectory of COVID-19 and the economic response over the next few months are still uncertain. Industry models show a wide variation in projections on the economic impact on GDP. Our research indicates that advanced economies like the US, Europe and the UK are likely to end this year with negative GDP growth in the range of -2% to -6%. We base this on three hypotheses of recovery patterns.

Three Possible Recovery Patterns

On the Aggressive Recovery Hypothesis, we believe that aggressive social distancing combined with a rapid discovery of effective treatment could jumpstart an economic recovery as soon as June 2020. In this scenario, we would expect to see the reopening of retail shopping and partial opening of travel and business operations. By August, work from home and school restrictions should be lifted and will be followed by a complete reopening of nonessential businesses, restaurants and large events. This model is projected to bring the overall economy to the 2019 performance mark with a negative loss. While this model is the most desirable, the probability of it occurring is low at around 20%.

A more likely scenario is a **Moderately Paced Recovery Hypothesis**, where voluntary adherence to social distancing remains in place by society at large but with inconsistent adoption. This will likely somewhat slow consumer demand and delay progress on effective containment of the virus. If available, contact tracing (the process of identifying people and locations where a confirmed COVID-19 patient may have visited or had contact with during the asymptomatic phase of his or her illness) could help support the reopening of business, retail and travel. Nonessential businesses could also be restarted in a controlled fashion. We anticipate that this approach will create a delay in the pace and duration of the economic recovery, with negative impacts to the business ecosystem as we know it. It will almost certainly force heavily impacted industry segments to reevaluate their current business operating model to reemerge with a very different target operating model. The research models suggest this is a highly possible scenario with a 50% probability.

The third possibility is a **Prolonged Recovery Hypothesis**, in which societal pressures force a rapid business reopening with limited testing and minimal controls on social distancing and few contract tracing measures in place. This model is likely to result in a short period of economic boom followed by a slow-down caused by a resurgence of the pandemic. An FDA approval of an effective treatment will create the second trigger for the reopening of businesses. Our informal research shows this scenario has about a 30% probability, with an initial recovery in June or later in the year following August. The second recovery, following the second slow-down, could happen in late 2020 or early 2021. In this model, we will likely see a significant GDP impact that is greater than -6% relative to last year.

Building Your Finance Response to COVID-19

Mark Twain once said, "The man who doesn't know where he wants to go, shouldn't be surprised when he ends up there." As you can see from these three patterns, there are numerous possible forks in the road to consider when planning your business restart. Most CFOs have already started down the path of defining their response plans to address possible scenarios. In doing so, they have applied specific actions against a short- term and near-term planning horizon.

Short-term strategies (6 weeks): The sudden and unplanned mandatory closures of parts of the economy compounded by the voluntary actions related to social distancing have created an immediate focus on cash preservation. In addition, there is a pressing demand from market analysts to understand the outlook and guidance. As a result, most CFOs have developed a three-pronged approach which involves establishing a finance task force focused on:

- Cash preservation
- Pandemic forecasting

- Sustaining operations in a new remote workforce environment

Near-Term Strategies (6 Months): In parallel, many CFOs are pulling together a finance strategy board to help shape the Near-Term strategy. Depending on the severity of their industry impact, these teams are helping shape the following activities:

- Hibernation and Business Restart Sequence Planning
- Impairment Assessment and Remediation Planning
- Funding and Credit Line Assessment and Remediation Planning
- Inventory Valuation and Fixed Overhead Revaluation
- Fair Value & Revenue Recognition Assessment and Strategies
- Supply Chain & Partner Stability Re-valuation

10 Focus Areas for Your Finance Response Strategies

Cash Preservation: Cash preservation is currently the top focus area for almost all CFOs. Their teams are evaluating options to defer or minimize outbound cash flow through extending or renegotiating of payment terms or looking at furlough options for employees. They are also considering strategies to maximize the inflow of cash through a focus on current receivables, targeted identification of collection and creating enticing early payment options for the customer (to create guaranteed supply). We also recommend considering a dedicated platform for addressing the day-by-day action plan to ensure status-tracking of critical customer and vendor receipts and payments.

Pandemic Replanning and Market Guidance: This pandemic caught every nation and every business by surprise in its scale, size and reach. It has not only created a need to revisit the existing financial forecasts, but there is also a need to revise current models to incorporate this type of event as a new risk factor. Furthermore, these models will need to be run against the previously mentioned scenarios and recovery horizons.

Sustaining Operations: This brings us to the sustaining operations challenge. Finance was not ready to handle these new complexities while also adjusting to a remote workforce model. CFO teams are now trying to quickly ramp up and adapt to new ways of delivering work. Collaboration tools are being used to help drive clarity on ownership, accountability of tasks and a cadence for daily sync-ups via online team meetings.

Hibernation and Business Restart Sequence Planning: The short-term response plan should cover the basics of identification of a "sustainable minimum." The finance strategy board can then focus on developing a "shut down" and "restart sequence" to enable the business to operate in a hibernation model until there is an identified recovery horizon. The components in the shutdown and restart sequence should consider when and what to do around:

- Research & Development (R&D)
- General & Administration (G&A) functions
- Vendor payments
- Raw inventory
- Production operations
- Finished goods inventory
- Distribution operations

Impairment Assessment and Remediation Planning: The strategy board will also need to look deep and far around the impairment aspects of goodwill. Is it possible to foresee a direct or indirect implication on the expectation of future cash flow from this pandemic? The board needs to consider whether the event caused a significant drop in the market price of assets or asset class. And it needs to consider if this pandemic event has caused an impact that warrants testing for impairment in goodwill or long-lived assets.

Reviewing Funding and Credit Line Arrangements: Companies experiencing decreased revenue, higher operating cost and /or cash flow will need to look at alternative debt instruments. They will need to restructure debt agreements and obtain waivers in debt covenants. If any existing debt covenants have been breached, it will require reclassification of those debts from “long term” to “current” on the balance sheet.

Inventory Valuation and Fixed Overhead Cost Assessment: Supply chain disruption from COVID-19 has created the need to review the inventory-carrying value of short shelf-life products. In addition, inventory shortage and supply chain disruption have driven manufacturing levels to a new low. On the other side, fixed costs that cannot be allocated to production lines due to unused capacity must be expensed in the period it has been incurred. The finance strategy board will need to consider these reporting complexities into their assessment and response development.

Fair Value & Revenue Recognition Assessment: The market uncertainty and volatility have created an issue about fair value assessment. However, the current market pricing cannot be disregarded when defining the fair value of assets. In addition, companies need to also consider the revenue recognition variables around discounts, refunds, price concessions, bonus, and penalties while looking forward to new revenue guidance models.

Supply Chain and Partner Risk Assessment: Another critical variable to consider while creating your revenue guidance will be the supply chain and partner risk. The finance strategy board will need to evaluate the current supply chain and partner model to determine the risk posture and develop alternate strategies to develop revenue hypothesis based on various risk models.

Review Contractual Exposure: This is a time when the contractual commitment needs to be evaluated for the financial liability or favorable leverage. Force majeure (from the French "superior force") refers to an event that contracting parties agree could occur but whose timing and impact they cannot control. It is a way of agreeing, in advance, what will happen if there is a catastrophic event (like a pandemic) and the relevant parties cannot perform. To invoke a force majeure clause, the non-performing party must establish that it could have performed if the force majeure event had not occurred. There's one caveat: When a court interprets the scope of a force majeure provision, the words are important. It is not a legal doctrine, so without a specific reference to a pandemic, a force majeure clause will not apply. The finance strategy board will need to keep this mind when reviewing contractual documents.

Go beyond traditional "Leading Practices"

As CFO teams create their financial strategies to manage COVID-19 impact, they need to think beyond tradition leading practices to develop the response strategies. It's imperative that finance teams apply laser focus on here-and-now strategies with a six-week cash preservation focus and having a clear six-month plan aimed at restarting the business in line with the global economic reboot. This is one of the rare occasions where the precision and effectiveness of the short- and medium-term strategy will be far more critical than a longer-term strategy.

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