Surviving an economic downturn
Topic Gateway Series No. 52

Prepared by Audrey Besson-Levine and Technical Information Service
October 2008
About Topic Gateways

Topic Gateways are intended as a refresher or introduction to topics of interest to CIMA members. They include a basic definition, a brief overview and a fuller explanation of practical application. Finally they signpost some further resources for detailed understanding and research.

Topic Gateways are available electronically to CIMA members only in the CPD Centre on the CIMA website, along with a number of electronic resources.

About the Technical Information Service

CIMA supports its members and students with its Technical Information Service (TIS) for their work and CPD needs.

Our information specialists and accounting specialists work closely together to identify or create authoritative resources to help members resolve their work related information needs. Additionally, our accounting specialists can help CIMA members and students with the interpretation of guidance on financial reporting, financial management and performance management, as defined in the CIMA Official Terminology 2005 edition.

CIMA members and students should sign into My CIMA to access these services and resources.

The Chartered Institute of Management Accountants
26 Chapter Street
London SW1P 4NP
United Kingdom

T. +44 (0)20 8849 2259
F. +44 (0)20 8849 2468
E. tis@cimaglobal.com
www.cimaglobal.com
Definition

An economic downturn is defined as:

‘A worsening of business or economic activity. It may be related to a decline in a stock market, economic cycle, or corporate profits. An economic downturn may be a part of or precede a larger recession; however, a downturn does not necessarily signify prolonged negative growth.’

The Investor Glossary
http://digbig.com/4xkhm

The current economic downturn, originated by the sub-prime crisis in the United States in 2007, is usually referred to as the ‘credit crunch’.

‘A period where lenders are unwilling to extend or renew advances to existing or potential borrowers. Such conditions increase the likelihood of default by borrowers since they may find it impossible to obtain new funds.’

Moles and Terry, Handbook of international financial terms

Overview and background

The ‘credit crunch’ has now spread through all sectors throughout the world. However it is still too soon to be classified as a recession.

‘Industries related to the housing market aside, the current crisis is mainly generated by a lack of confidence and should not be compared to a full-blown recession just yet.’

Tim Luscombe, CEO, Management Advice

Nevertheless, while banks seek to reduce their exposure, companies have to face restricted access to liquidity and produce alternative sources of funding. Cash management then becomes very important and improving working capital is critical to a business’s survival. When investors, suppliers and auditors increase their focus on a company’s cash flow performance, the right tools and resources must be in place to maintain general trust.
In order to spread the risk of high-risk mortgages, investment banks bundled them with prime mortgages into ‘Collateralised Debt Obligations’ (CDOs). These were guaranteed to be safe by AAA ratings and to provide high returns. CDOs were then sold to investors around the world.

When sub-prime borrowers started to default on their payments and house prices began to crash, the value of mortgage-based securities fell. As CDOs had been unbundled and re-bundled so many times and listed on balance sheets as ‘Structured Investment Vehicles’ (SIV), it became difficult to determine the underlying value of the assets. Consequently, banks were unable to quantify their exposure. This generated a deep confidence crisis and nobody was prepared to lend anymore, which led to a worldwide liquidity crisis.

The initial impact was on financial services in the US. The real estate and construction sectors were next to be affected by the crisis. Soon the financial turmoil turned into a crisis of confidence and spread to the all sectors worldwide. In the UK, Marks & Spencer and the John Lewis Partnership announced falling sales, while the international housing and development group, Taylor Wimpey, closed offices around the country.

**Application**

As banks started to reduce their exposure, access to credit became limited and expensive.

The limited access to cash is now a challenge for businesses in need of additional liquidity to fund their growth. A survey conducted by the Small Business Research Trust, in conjunction with the Forum of Private Business showed that growth in investment by medium-sized companies in the UK fell from 27% at the end of 2007 to 9% in the first quarter of 2008.

Equally, companies going through market downturns or normal seasonal fluctuations, which would previously have survived by extending their credit facilities, may now be pushed into liquidation. This is especially true for start-up companies that tend to consume cash faster than they generate it in their early years.
Cash visibility is vital

Cash monitoring and forecasting are now very important for businesses. Investors will expect CEOs and CFOs to have the right tools and resources in place to be able to report the company’s cash position at any time.

Using the right methodology is critical when cash forecasting. The direct methodology is usually recommended as it avoids using variances and reprocessing the financial statements. It is important to make sure that all sources and uses of cash are taken into account, and it is essential to ensure stakeholder buy-in.

Tools used to forecast cash include rolling cash forecasts, daily cash availability reports and weekly cash analysis. Sensitivity analysis will help to anticipate worst-case scenarios. Ideally a business will be able to automate its peripheral cash related processes, such as receivables and payables, to enable cash forecasting.

Optimising the working capital cycle becomes essential

Cash management also requires underlying processes such as receivables, payables and inventories to be in place in order to optimise a company’s working capital.

The receivables process includes the following sub-processes that need to be closely monitored at a time when access to credit is difficult.

**Credit policy** - this should be well defined, signed off by the relevant parties and include key information such as credit criteria, standard payment terms and reporting needs.

**Invoicing process** - this is critical and should be accurate and timely. Discounts for early payments might be worth considering to speed up cash inflows. Payment facilities are important and electronic solutions will help increase the chances of being paid on time.

**Collection process** - this needs to be tightened. Routines and controls should be in place, with metrics like DSO (Days Sales Outstanding) monitored and receivables reports reviewed daily. The time allowed to collect money can be reduced if necessary. It is recommended that companies make reminder calls to their debtors before the collection date. Staff incentives can also be leveraged to improve the effectiveness of the collection process. Finally, if interest on late payment is included in the company’s policy, now is a good time to enforce it.
The payables process must be monitored closely to manage cash outflows:

- Purchasing policies should be in place. It is recommended that businesses consolidate their suppliers where possible in order to increase negotiation power on payment terms. Approval process for expenditures needs to be followed closely and a ‘no purchase order, no pay’ policy should be able to enforce it.

- Supplier payments should be scheduled on the very last day they are due, except where it makes sense to take advantage of early payment discounts. DPO (Days Payable Outstanding) needs to be watched and compared to industry benchmarks.

Inventory is another process that will have an influence on the working capital and requires extra attention when in a liquidity crisis:

- Managing inventory in relation to sales trends is recommended. Where it makes sense, a just-in-time inventory can be a preferred option, as this will prevent having cash tied up for an extended period of time.

- Metrics like inventory turnover, inventory levels or stock-to-sale ratios will help make the right decisions.

**Finding alternative sources of funding might be required**

Finding alternative sources of funding is the new challenge for senior management teams in a ‘credit crunch’ environment. Improving working capital is one solution. However, a company might still need additional borrowing and if the bank is hesitant to lend, alternative sources of cash must be found.

Cash pooling, although already an established product, is not applied everywhere. Cash can be managed more efficiently by having strong controls in place, decreasing borrowing needs, optimising cash return and having easier access to funds. With the new European initiative SEPA (the Single European Payments Area), cross-border cash pooling is definitely worth considering.

Other options are available and particularly attractive during the more uncertain credit and trading conditions:

- Factoring and invoice discounting will help to accelerate the cash cycle, although receivables will be sold at a discount. As terms vary between factoring companies, it is worth shopping around. Some banks will also accept a loan using receivables as collateral and the fee will usually be cheaper.
• Selling non-core assets is another option for a larger cash injection. Property sale and leasebacks are also worth considering.

• Businesses might need to consider delaying investments. Capital expenditure aimed at growth might not be a priority, as cash management takes priority.

Financial reporting becomes more challenging in a volatile environment

Accounting for balance sheet items at fair market value becomes complicated in an unpredictable environment. There have been multiple debates regarding the relevance of the fair market value method in the ‘credit crunch’ environment, but its continued application in the preparation and audit of financial statements has been confirmed.

Three asset levels are defined in FAS 157, published in December 2007.

• Level 1 assets have a liquid market.

• Level 2 assets can be valued by reference to a liquid market in a related asset.

• Level 3 assets do not have a liquid market and need to be valued by internal mathematical models using the business’s best available information. This is referred to as the mark–to-model valuation technique.


Restricted access to credit might lead companies into a situation where the ‘going concern’ assumption is no longer valid. Therefore auditors will have to verify the existence and terms of a company’s bank facilities. If these are no longer available, auditors will disclose them in the financial statements as well as in their auditor report.

It might be a challenging experience, but surviving an economic downturn is possible for a company that has the right processes, routines and controls in place. It requires a back to basics approach and the application of common sense to all aspects of managing cash.
References

Faux, J. *Is this the big one?* Nation, 14/4/2008, Volume 286, Issue 14, pp 11-14
Tett, G. *European banks hit harder by credit crunch.* FT.com, 5 June 2008
Available from: [http://digbig.com/4xkgx](http://digbig.com/4xkgx)
[Accessed 2 September 2008]


[Accessed 2 September 2008]

[Accessed 2 September 2008]

[Accessed 2 September 2008]

[Accessed 2 September 2008]

[Accessed 2 September 2008]

[Accessed 2 September 2008]

[Accessed 2 September 2008]
Further Information

Articles

Full text available from Business Source Corporate through My CIMA
www.cimaglobal.com/mycima
[Accessed 2 September 2008]


Colvin, G. The next credit crunch. Fortune, 1/9/2008, Volume 158, Issue 4, p. 30

Colvin, G. The next credit crunch. Fortune International (Europe), 1/9/2008, Volume 158, Issue 3, p. 23


CIMA Publications

Besson, A. Surviving a liquidity crisis. CIMA Insight, August 2008
Available from: www.cimaglobal.com/insight
[Accessed 2 September 2008]

[Accessed 2 September 2008]

[Accessed 2 September 2008]

Books


Online publications


Websites

BBC News

The Association of Corporate Treasurers,

The Institute of Chartered Accountants