Dealing with the unexpected

Uncertain times challenge key assumptions for finance directors, says **Pesh Framjee**

Most not for profit organisations have recognised that it is not business as usual and there are new challenges that require specific attention. It is widely acknowledged that the recession is impacting on charities in a number of ways – and will continue to do so.

Back in March 2009 the Charity Commission released their latest *Economic Survey of Charities*[1] which illustrates the deepening impact of the recession on charities. The report's key findings were:

- 52 per cent of the charities surveyed say they have been affected by the financial downturn; of these, 58 per cent have experienced a decrease in income;
- 32 per cent of charities say they have taken steps to combat the effects of the downturn; and
- 64 per cent of charities with an annual income of over £1m are concerned that the downturn is going to affect future work.

The task of setting priorities remains as difficult as ever; in other words matching the demands to satisfy short-term needs against pressure for the resources required to achieve long-term solutions. The operating environment is becoming even more demanding and plans for future strategic development will have to take into account a number of new factors. It is a world in which priorities need to be constantly reassessed and organisations needs to be nimble and flexible. Knowledge has to be not only accurate and relevant but attuned to analysis from different perspectives.

In my discussions with the organisations I work with it is apparent that there is a need to revisit and rethink many of the accepted assumptions in:

- Strategy and scenario planning
- Risk management
- Structures and operations
- Reserves and treasury management

How has your strategic planning process changed?

A *Mckinsey Quarterly Survey* conducted in April 2009[2] shows that across all sectors. 47 per cent of respondents thought their current strategic planning process was somewhat different from the prior year and 34 per cent thought it was extremely different. More rigorous approval processes for new projects and expenditure and a focus on a shorter timeframes are the key areas of change. As a result, strategies become more dynamic, focused on the short term, and contain more analysis. The organisation has to be ready to react to outcomes that are different to earlier predictions and events that require strategic adjustment. This means regular monitoring and measurement of progress against the strategy – many organisations are now doing this monthly. This is more than preparing management accounts and variances from budgets.

The strategy must be able to deal with uncertainty and at a time when predicting the probable is difficult to say the least, strategies and tactics have to be developed on the premise that several different outcomes are possible.

Respondents to the Mckinsey survey reported scenario planning as the element that has been most valuable in helping them cope with this year's uncertain environment and non profits have been using this tool, factoring in a range of possible outcomes. The exercise means that finance directors have to put values and analysis on different scenarios and this does require some out-of-box thinking.

This can lead to confusion. Common problems are that scenarios are wrongly treated as forecasts[3] and the range of scenarios is too simplistic – for example optimistic and pessimistic. The aim of a successful scenario planning process is not an accurate prediction of the future but to deliver a means by which an organisation can learn, adapt and take effective and timely action by preparing it for what might happen in the future.

Another reason why scenario planning is not very effective is the lack of out of box thinking. Good scenario planning requires many perspectives and this involves engaging with a diverse team across functions in the organisations and also perhaps to include external perspectives to identify threats and opportunities that may have been overlooked. However, the focus on new scenarios and the immediate issues should not mask important long-term trends or undervalue relevant existing strategies.

The identification of potential scenarios needs to involve more than the finance function which has an important role in monitoring and tracking the key indicators that give early warning of the imminence of a particular scenario. These indicators should be seen as signs of potentially significant change and need to be selected and monitored with great care. Each organisation may well have very different choices of indicators – for example average gift size may be critical to one and foreign exchange rates may be critical to another.

A number of charities have developed action plans for different scenarios by setting and monitoring trigger points along with trend analyses. These make it possible for the charity to decide when plan A or plan B needs to be implemented. For example, 'if income looks like it is going to drop by X we will do Y…'

Have you taken account of the new thinking on risk?

The lead responsibility for coordinating and monitoring risk management is usually taken by the finance function or internal audit. The unprecedented events in the last two years has led to a new awareness of the importance of remote events that can have a significant impact and this casts some question marks over the way we have traditionally identified and scored risks and adopted procedures to manage them.

Traditional risk management methodology focuses on considering both impact and likelihood or probability of a risk and giving them equal importance. The impact score is usually multiplied by the score for likelihood and the product of the scores used to rank those risks that the trustees regard as most serious. Therefore with a scoring system of say 1 to 5 a risk that has been assessed as very high in both likelihood and significance will have a score of 25 (5x5). A risk that has a very high significance but a very low likelihood will have a risk score of 5 (5x1) as will a risk with very high likelihood and very low significance. In effect this scoring gives equal emphasis to impact and likelihood. This is the methodology that has been popular in the past and the approach described by the Charity Commission[4] and many of the other discussions on risk methodology used in the charity sector.

The thinking has moved on and there is greater recognition that probability has less value for risks that occur outside the norm. This means that approaches will have to be incorporated to deal with a new financial climate and new challenges. Risk management needs an overhaul in turbulent times: especially when events are rare or unprecedented; where the rules are unknown or rapidly changing; or where causes are driven by external factors beyond the organisation's control. In such instances, the concept of vulnerability and risk interaction should assume prominence in both the risk assessment and risk management processes.

If an organisation is vulnerable to a risk that is both relevant and has extremely high impact, it should be addressed, regardless of 'remote' likelihood. However, 'addressed,' in this context, is not necessarily the same as 'mitigated.' A balance needs to be attained and vulnerability should be weighed alongside probability. Non profits are invariably resource constrained and risks and rewards will need to be considered. Furthermore, the board will need to establish their risk appetite and the risk tolerance that they are ready to accept. However it is important to recognise that sometimes improbable events do occur with devastating effect, while other times probable events fail to materialise.

A focus on high-impact risk is important, but one should not forget how a lower significance risk can escalate to very high impact risk because of risk interdependancies. An isolated concentration on value at risk can sometimes result in finance directors not spotting 'risk contagion' – in other words where one low impact risk leads to another and another so that the cumulative impact is catastrophic. Many studies have shown that most business failures are the result of a series of small, linked events rather than a single large event. If organisations only look at the big risks they can often end up lethally ill-prepared to face the interaction of separate adverse events. *See also* my article on value protection and value creation in *Caritas*, issue 2, January 2008, page 30.

Have you restructured enough?

Many finance directors have been ready to acknowledge that there is often scope to review the way things are done with the aim of increasing productivity and/or reducing costs. Many years of uninterrupted growth have sometimes allowed unnecessary complexities to flourish in organisational processes and structures. More generally in all sectors revenue growth is often to blame for not taking a good hard look at how efficiently activities are carried out and services are delivered.

Similarly, peripheral and non-core activities have quietly taken seed and diverted resources from core activities. Organisations are finding that activity value analysis is a good way of deciding which activities add value and which do not. As activities develop, errors and waste often creep in so that reworking and correction time is accepted as part of the normal routine. To understand how to save costs on activities it is important to understand the core processes and sub processes and their role in achieving the expected deliverables and the overall organisation strategy. *See also* my article on cost optimisation in *Caritas*, issue 2, December 2008, page 30.

Finance directors who found it very difficult to implement unpopular operational changes and cuts now have more leverage with the rest of the management team, the board and staff. A recession is a time when the organisation is more receptive to the need for change and the need for some tough choices. This puts the organisation in a better position to take advantage of the recovery when it comes.

Reserves and liquidity

As income levels are threatened, cash flow and reserves management inevitably demand more attention. Finance directors should reassess their reserves policy and ensure it meets operational needs. Unfortunately many reserves polices are often created to justify the existing level of reserves rather than what is realistic and operationally necessary.

The reserves policy should link with the risk management and forecasting process. This may require a rethink on why the organisation needs

reserves and what the appropriate level is. To do this properly a full understanding of any problems forcing the organisation to dip into its reserves is required, and operating realities must be considered. Analysis of the options open to the organisation when dealing with the actual problem in hand should follow. Key to this is an understanding of income and expenditure flows and the nature of the reserves.

This means asking what the reserves represent and looking at the ease with which they can be made available in times of need. For example, if the reserves are represented by tangible fixed assets then their availability for use will be different from stock market investments. Many charities have recognised that they are going to have to dip into reserves to manage cash requirements. The issue is how is the reduction in reserves going to be managed. Are funds going to be obtained by borrowing, selling investments or drawing down on cash balances?

The continued uncertainty and volatility of income has dramatically increased the exposure to liquidity risk; underlining how vital it is to have robust assumptions behind forecasts. Finance directors need to ensure that there are processes in place to ensure that appropriate procedures and controls have been applied to the use of models to generate cash flow and income information, including the choice and consistent use of key assumptions. *See also* my article on reserves management in *Caritas*, issue 17, April 2009, page 13.

Other guidance

The Charity Commission has recently published guidance for trustees on the issues they need to be considering during the economic downturn. *Big Board Talk*[5] is in the form of 15 questions organised into four broad areas:

- Strategy – opportunities and risk
- Financial health
- Governance
- Making best use of resources

On 17 December 2007, the Financial Reporting Council (FRC) released a Press Notice 204 advising preparers of accounts, members of audit committees and auditors of the need for additional diligence in light of the increased risks to confidence in corporate reporting and governance arising from current credit market conditions[6].

In November 2008 the FRC also released a document listing the key questions audit committees should consider in light of the current economic conditions[7].

Summary of key points

- Strategy in a downturn needs to take account of different factors.
- The status quo is rarely the right option.
- Strategies have become more dynamic, focused on the short term.
- Monitoring and measurement of progress against the strategy is more frequent
- Strategies and tactics have to be developed on the premise that several different outcomes are possible.
- Scenario planning is valuable in helping cope with the uncertain environment.
- There is a need to put values and analysis on different scenarios and this requires out-of-box thinking from different perspectives.
- Scenarios are wrongly treated as forecasts and the range of scenarios is too simplistic.
- The focus on new scenarios should not mask important long-term trends or undervalue relevant existing strategies.
- Charities have developed action plans for different scenarios by setting and monitoring trigger points along with trend analyses.
- There is a new awareness of the importance of remote events that can have a significant impact.
- Probability has less value for risks that occur outside the norm.
- If a risk is both relevant and has extremely high impact, it should be addressed, regardless of 'remote' likelihood.
- Lower significance risks can escalate to very high impacts risk because of risk interactions.
- It is important to understand the core processes and sub processes and their role in achieving strategy.
- The reserves policy should link with the risk management and forecasting process.
- Understand what the reserves represent and looking at the ease with which they can be made available in times of need.
- The continued uncertainty and volatility of income has dramatically increased the exposure to liquidity risk.

1. www.charity-commission.gov.uk/Library/ common/downturn.pdf
2. www.mckinseyquarterly.com
3. A useful article on range forecasting can be found in *Caritas*, issue 16, March 2009, page 13.
4. *See Charities and Risk Management:* www.charity-commission.gov.uk/investigations/charrisk.asp#9
5. www.charitycommission.gov.uk/Library/tcc/pdfs/ccnews29check.pdf
6. www.frc.org.uk/press/pub1467.html
7. www.frc.org.uk/images/uploaded/documents/Challenges%20for%20audit%20committees%20November%202008.pdf

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