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COVID-19 – Impacts on companies and their risk management: first thoughts on the role of the independent directors

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The effects of coronavirus

The effects of COVID-19 on corporations has hit practically all sectors of the economy. The first estimates indicate that it will be unlikely that economic losses will be recovered within the year.

In China, the first nation struck which now appearing to be in a plateau, the measures of prevention of further spread of the epidemic, mainly the limitations on the movement of people, have generated for some months a substantial reduction in the production capability and a contraction of sales in many product categories and in services such as travel and tourism. The Chinese government has adopted extraordinary measures to support businesses which operate in the health sector and those which are suffering the greatest losses. These measures include fiscal benefits as well as financial support, at least in the short term. Similar measures are being evaluated in European countries. Italy, one of the hardest hit countries is one of them. However, the ability to estimate the amount of resources necessary and the way to allocate such resources is difficult.

The risks around a pandemic involve not only the health of the populations at a global level but also economic sustainability. Impacts go beyond the risk management of even the most modern organizations and social systems. Previous studies on pandemics (Ebola, SARS, etc) have demonstrated that the economic effects push towards recession and effects, as we are in fact observing, at an international level.

The role of Boards of Directors

Corporate responsibility, in the current period of approval and communication of financial results and outlooks, is essential. Many corporations have already manifested that sense of responsibility, communicating preliminary evaluations of potential impacts and areas of risks and uncertainties.

Board directors must reflect on the effects of this crisis in the medium and long term, reconsidering strategies and diverse impact scenarios. They must promote, adopt and monitor the implementation of adequate alternative structured plans and policies of risk management to address this more than emerging risk of pandemic.

Measures of risk management that companies have taken in these first weeks (crisis committees, contingency planning, business continuity measures) and the adoption of smart working practices have proven immensely useful. Many more actions, under the current circumstances, are necessary. Even when international corporations have sophisticated risk management tools for analyzing inter-related risks and projecting effects (enterprise risk management models, sensitivity analyses and so forth), there are limited examples in which the risk scenario impact analyses regarding pandemics have been developed.

The situation drives companies to consider new tools to assess and evaluate their own business models, and their own vulnerabilities in order to test the sustainability of their businesses in light of crises like these.

How can independent Board directors contribute?

Best practice in crisis management distinguishes short term and medium-long term initiatives. Independent directors should ensure that the company is moving in at both levels. The crisis management committee needs immediate response mechanisms as well as long term planning.

Short term actions

The first phase should permit identifying and presiding over more immediate business risks, considering the concentration of business, both supply and market, in certain countries, and needs or opportunities for localization versus de-localization.

Independent directors should check that the Board's agenda includes the evaluation of the adequacy of the short term response plan. In the discussion, directors should consider the many areas of potential initiatives:

- The deliberation of measures regarding **employee safety**, work conditions, respect of health and safety rules in the various company environments (office, production facilities, branches), promoting the use of smart working e videoconferencing and good communication of procedures.
- Verifying the **strength of overall operational processes**, considering possible suspension of some processes which are not practicable in an emergency situation like this one, and evaluating potential automation opportunities.
- creation of a **liquidity buffer** in order to address new cash flow needs in connection with the, for example, supplier difficulties, employee relations and customers.
- A further evaluation of the **supply chain** in relation to, for example, the search for new supply sources in the various geographical areas or methods of stock management. Assessment of contractual terms with suppliers could help identify some opportunities of risk sharing with the counterparties.
- **Protection of customer relations**, ensuring close communication through digital solutions and, if appropriate, offering financial flexibility.
- Potential selective review of **capital expenditures and the budget** in general.
- Review of **IT continuity** in a context that extends to revised communication mechanisms and smart working, with the related cyber risks that accompany them.

Again, crisis management systems can require efficiency initiatives with specific focus on a Sourcing Continuity Plan.

A particular emphasis is placed on communication (to customers, to employees, to investors, etc) which should cross all the phases of the principal processes, ensuring transparency and full cognizance.

Finally, the integration of health indicators in the various scenario analyses that are conducted by the company could improve the evaluation of investment opportunities in the various countries.

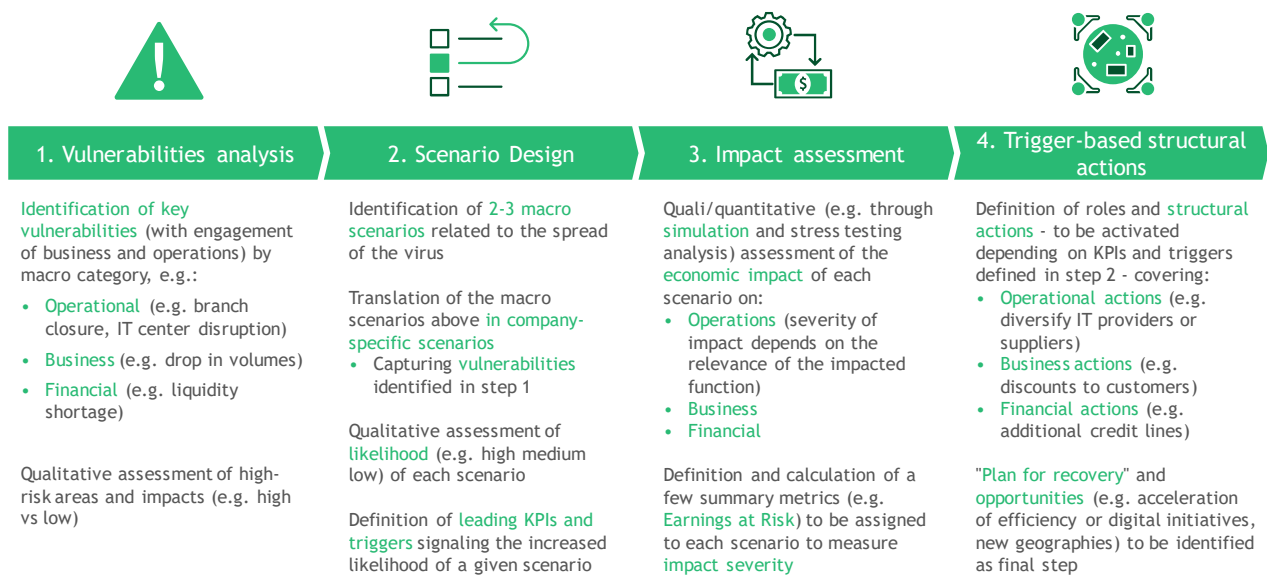
Medium/long term initiatives

In addition to addressing the crisis with emergency actions in the short term, management should progressively consider the impact of the crisis in the medium/long term.

In this context, the support of the independent directors could be a stimulus to reflect on the issues and promote structured analyses versus approaches based on instinct and intuition.

For this reason, the following illustration offered by Boston Consulting Group, offers a valid methodological approach towards scenario planning:

4 steps for a structural scenario-based management of the crisis



Source: BCG: White Paper COVID-19: Sustaining Business in All Scenarios, March 2020

Scenario planning takes place in four steps:

Step 1-Vulnerabilities analysis,

The first step will deliver a set of vulnerabilities associated with the organisation's business, operations, financial management with subsequent assessment for relative impact (high vs low).

Step 2- Scenario Analysis

The definition of scenarios, meaning the identification of a limited number of macro-scenarios on the basis of probability (for example the level of health related scenario or event related scenario in any given location). These are then translated into company specific scenarios whereby the consequences in terms of supply risks, production risks or commercial risks are defined and leading KPIs and possible trigger thresholds are determined (with the associated probability assumptions).

Step 3 - Impact Assessment

The assessment of the potential economic impact of each scenario (business, operational, financial) through the simulation of a limited number of metrics (for example earnings at risk).

Step 4 – Trigger Based Structural Actions .

The identification of corrective actions to take (business, operational, financial) in each scenario (on the basis of the triggers previously identified in step 2. These actions can regard the diversification of suppliers, the offer of discounts towards customers or the activation of new lines of credit. A plan of “recovery and opportunities” follows.

These steps must absolutely be made through the involvement of top management, including the CEO, CFO, heads of business units, and risk manager. It may be useful the use of outside consultants in to promote a truly structured approach, the full integration of diverse information sources within the enterprise and an independent eye from management.

The four step approach allows the company and its Board to achieve a broad vision, even gradually with the accumulation of information. The Board can share different medium – long term scenarios and thus prepare for different response strategies.

The independent Board Director should encourage a scenario-based management to reformulate strategic plans and budgets and at the same time address and mitigate potential impairment issues in the financial statements.

The process is neither quick nor easy, given the enormous uncertainties around the evolution of this epidemic.

Board meetings will be various, in order to continue to monitor the crisis plan and assess the sustainability of the budget and the medium /long term plan. Over time, new mindsets, able to reconsider the business model in the light of this crisis, will be called for.