

# Director Alert

## The Global Financial Meltdown – questions for directors to ask

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### Introduction

Companies around the world are confronted by a perfect storm: frozen credit markets, a looming global recession or worse, equity markets that have succumbed to panic, and interventions of uncertain effectiveness by central banks and regulators. Not long ago, many argued that there was a new resilience in the world economy as emerging countries had decoupled from a reliance on the economic health of the U.S. But now there is growing evidence that world economies are even more interconnected and symbiotic than anyone really understands. Moreover, events are moving so rapidly that it is almost impossible to assess the implications of the meltdown for the days ahead, let alone the years.

Canadian companies are not immune from this turmoil; they already face exceptional economic challenges:

- a volatile currency;
- constraints on liquidity, credit and access to capital;
- decreased demand from our largest trading partner;
- fluctuations in energy and resource prices;
- a regulatory environment that will inevitably change some of the rules of finance and leveraging; and
- national economies around the world whose banking systems seem to be teetering on the precipice.

Yet, while these challenges may be creating negative business sentiment and pessimism, there may also be opportunities that some companies are well positioned to capitalize on. The key is to measure opportunities against significant and unknown risks.

What are directors to do in these volatile times? To avoid the pitfalls and understand the possibilities, directors are encouraged to ask questions to understand what is happening and to ensure management is preparing and positioning corporations for what lies ahead. These are not questions to which there will be immediate or easy answers. These are questions that try to assess what directors know and what they need to know in the following areas:

- the economic circumstances in Canada and the markets for a company's goods and services;
- current and future constraints affecting liquidity and financial condition, including credit lines and access to capital,
- the possibilities of collapsing deals and their implications;
- the impact that events will have on the value of the Canadian dollar;
- what the regulatory environment will look like if new banking and finance rules are created in response to this crisis;
- the likely impact that all of these events will have on Canadian and global consumers and investors whose attitudes and sentiments will shape how this crisis ends and eventually shifts to a better business environment; and
- the company's actions and plans to respond to these challenges.

Some of these issues, such as those affecting finance, are short-term and demand immediate attention and reaction. A greater challenge, however, is predicting the long-term impact of the current crisis. This Director Alert, while discussing both short and long term issues, focuses more on the long-term – the forward-looking and strategic fallout that will confront companies and their management in the months and years ahead. The Alert presents a series of questions as a catalyst for useful dialogue. Not all of the questions will be relevant to all companies. Many of the questions are intended for directors to consider asking management, others are questions for directors to discuss among themselves. They fall into four categories.

- Uncertainty, Risk and Business Strategy
- Financial Condition and Liquidity
- Reporting and Disclosure
- Leadership and Corporate Governance

## A. Uncertainty, Risk and Business Strategy

Business strategy and risk assessment need to focus on the possible implications of a wide range of current and forward-looking economic scenarios. Different economic scenarios - even extreme scenarios - should be contemplated, as well as how these scenarios can be worked into an enterprise-wide business strategy - one that addresses both risks and opportunities.

1. What have the operational and financial impacts been to date on the company as a result of the global financial and economic meltdown?

**Consider:** In what ways is our current business strategy affected? What changes to previous strategic planning assumptions are required? What could the impact be on previously anticipated financial results? What has been communicated to capital markets (and when) about such impacts?

2. What assumptions has management made about the state of the economy and capital markets in assessing and addressing the implications of uncertainties and risk on the company's business strategy? Over what time frame?

**Consider:** Did management evaluate the implications of various economic scenarios over different possible timeframes in deciding on a particular scenario? On what basis did management decide which scenario is the most appropriate? How good is our track record in anticipating changes in market conditions?

3. Under the economic scenario and assumptions selected by management for addressing what lies ahead, what are the most important (a) short term (immediate) and (b) longer term implications for the company?

**Consider the implications for matters such as:**

- *Operations:* e.g. sales and revenues, operating costs, inventories, interest, working capital,
- *Capital projects:* in progress, previously approved but not yet commenced, proposed but not yet approved, etc.
- *Mergers and acquisitions:* whether our M&A game plan needs to be reevaluated to take into account the current financial situation as well as scenarios going forward. Should we now be considering acquisitions? Is the company likely to be the target for a hostile takeover?
- *Opportunities:* whether the current financial and market turmoil has created unforeseen, opportunities for the company.
- *Risk management strategies:* whether volatility necessitates re-considering the appropriateness of strategies such as insurance and hedging.

4. Are there ways in which the effects of market uncertainty and the future of the economy on our company differ significantly from the actual or likely effects on our competitors?

5. Is the company sensitive to political risks and uncertainties that the crisis may create or exacerbate?

**Consider:** Has the political environment changed or is it likely to change in areas where we have global operations, sell to consumers or rely on supply chains? How serious might the impacts of such changes be?

6. In light of the above factors, what are the immediate actions management is proposing for the short term? and

7. What are the key features of business strategy and risk management proposed for the next year or longer?

## B. Financial Condition and Liquidity

It is likely that financial issues will have the first and most formidable impact on many Canadian companies. Financial capacity issues need to be considered in relation to their impact on business strategy.

The financial condition of many companies will be affected by constraints on liquidity, tight credit and more difficult or expensive access to capital, which in turn are likely to impact business operations or result in projects that cannot be financed as planned. Mitigating the impact of such constraints will become a priority concern.

1. What are the effects of the market meltdown on the company's liquidity (shorter term) and financial condition and strategy in the longer term? These effects could be numerous and inter-related.

### Consider for example:

- How serious is the company's sensitivity to global currency fluctuations or devaluations, as well as Canadian dollar fluctuations?
- Is the company sensitive to regulatory changes that may result from the financial crisis, such as changes that might affect financial institution leveraging capacity?
- What are the implications on the company's financing strategies if equity markets continue to be volatile and negative or borrowing becomes difficult or more expensive?
- Do investors still have confidence in the company's stock? Have our credit ratings been affected? Are we able to meet the terms of existing debt? If not, will we be able to refinance as necessary?
- Is the company able to meet its pension fund obligations? How might such obligations affect our financial condition for business operations, project financing, etc?
- Have the company's hedging and risk management strategies created problems or unintended consequences?
- Does the company have investments that it should divest or liquidate in order to strengthen its financial condition?
- Are there significant tax implications associated with any actions taken or planned to address financial concerns?

## C. Reporting and Disclosure

Significant changes may also be on the way in the reporting and disclosure areas. Investors and consumers have lost some confidence in how the financial system works, and may have lost confidence in corporations and the transparency and integrity with which business is conducted.

Every company needs to consider whether its financial reporting, disclosure and other communications are adequate to meet the expectations of investors, regulators, consumers and employees and thereby to maintain or restore confidence in the company.

It is even necessary to consider and evaluate the premise that a company is a going concern – a possibility that investors may be considering in view of recent collapses and bailouts, and of the operating difficulties and financial constraints some companies may face.

Boards and directors need to be vigilant in ensuring that disclosures are neither deficient nor misleading in addressing crisis-related reporting issues.

1. What is being done to communicate with investors, bankers and shareholders in these times of turmoil? Are disclosures effective and timely?
2. Do MD&As communicate effectively about matters that may not previously have been the focus of the company's MD&A disclosures?

### Consider such matters as:

- the effect of recent volatility on the company's results, distinguishing, if possible, between episodes of growth and no growth, or decline brought on by changes in markets;
- strategy for dealing with volatile credit and consumer markets;
- impact of banking disruptions on management of liquidity and the funding of operations and capital projects;

- the impact of significant uncertainty on accounting estimates embedded in items in the financial statements;
- revising disclosures about risks discussed in previous periods' MD&As; and
- the factors that will contribute to a turnaround or recovery, or, on the other hand, factors that may challenge the company's ability to finance its operations in the normal course of business in order to continue as a going concern.

3. Is forward looking information in the MD&A reasonable for meeting investors' needs and expectations, while also complying with regulatory requirements about such disclosures?

The exceptional level of volatility and uncertainty that companies face presents special challenges for providing useful forward looking information.

## D. Leadership and Corporate Governance

Finally, there are important governance issues that sooner or later will confront boards. Corporate governance practices are likely to come under greater scrutiny in response to concerns that existing governance practices may have made an already bad financial situation even worse. CEO and board selection and composition, executive compensation, risk management, focus on long term value creation and shareholder activism will be among the many corporate governance issues likely to reverberate throughout the corporate world.

1. Are the current CEO and management appropriate to respond effectively to the market and economic environment the company faces?

**Consider:** Selection of the current CEO and CFO may have been based on leadership qualities and skills perceived to have been appropriate to develop and execute strategy under circumstances and assumptions different from those the company now faces.

2. Does the executive compensation structure, including embedded corporate and CEO performance objectives, need to be adjusted in light of new business conditions and performance expectations?

3. Is there need for change in board committee structure, modus operandi (e.g. frequency of meetings, information to board members, focus on risk, risk tolerance and strategic plan, etc.) or other aspects of governance to strengthen the board's oversight role during difficult times?

4. With the benefit of hindsight, what signs might we have seen that could have caused us to anticipate difficulties or respond differently?

**Consider:** Did we receive information that might have revealed early warning signals? In our interpretation of information, did we overlook such signals?

5. What might we learn and do differently in the future to be better able to predict and respond to imminent market and financial crises?

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