PETER SCOTT CONSULTING

COVID-19 pandemic – stress testing the financial implications – a practical example

In last week's bulletin, we spoke about the importance of stress testing your forecasts against the backdrop of a number of different scenarios. We are seeing very different short-term expectations amongst clients, but the common theme looking forward to 2020/21 is uncertainty and difficulty setting budgets and forecasts.

For this bulletin we have used our financial model to look specifically at the financial implications of a sharp deterioration in work and the options to mitigate the impact on profitability and cash flow for a representative firm. All the numbers have been anonymised but are derived from real data. At this stage we have reflected the government's advice that the economic crisis will last a minimum of six months.

Our representative firm achieved fee income of £12.4 million and a profit of £3.3 million in the year to 31 March 2019 and had an overdraft of £0.2 million at that year-end. Prior to the COVID-19 pandemic it expected to achieve a 3% increase in fee income in the year to 31 March 2020 and earn a profit of £3.5 million. Furthermore, fee income and profits were expected to reach £13.1 million and £3.6 million respectively for the year to 31 March 2021.

Based on the above profitability, the cash balance at 31 March 2021 would be expected to be £1.7 million if no prior year profit distributions were to be made (this enables us to compare this outcome to the outcomes in our model as distributions are deferred in the stress testing scenarios below as that's the minimum expectation banks will have of firms and a sensible precaution by firms now).

The following table illustrates the impact of the sharp deterioration in work on the year to 31 March 2021's performance, assuming no changes in expenses:

Scenarios	Fee income	Profit	Cash position
25% fall in time recording for six months	£11.8 million	£2.2 million	£0.1 million
50% fall in time recording for six months	£10.4 million	£0.9 million	(£1.6) million

Note – key assumptions in calculating these scenarios

1. *The decline in time recording is effective from 1 March 2020*
2. *WIP/debtor ratios don't change during this period*
3. *The cash flows do not include the savings the firm could achieve as a result of reducing discretionary expenditure nor any benefit from the government's CJRS or other staff savings as outlined below*
4. *The cash flows do not reflect any reduction in partners' monthly drawings but prior year profit distributions are deferred*

Profitability

This firm has 20 equity and fixed share partners so average profit per partner for the year to 31 March 2019 of £165,000 would fall for the year to 31 March 2021 to £110,000 with a 25% fall in time recorded over six months and to £43,950 with a 50% fall in time recorded for six months. Clearly, partners would expect the leadership team to consider steps to mitigate this fall in profitability. This could include (inter alia) freezing all discretionary spend, flexible working, furlough/accessing government schemes and redundancies.

Stopping all discretionary expenditure would have a reasonable positive impact; in this firm, approximately £0.4 million of savings could be achieved. This would improve cash flow by the amount saved and increase average profit per partner by £20,000 in both cases.

Given that property costs are likely to be fixed in the short term, the only material source of further savings is staff costs (usually a firm's single biggest overhead). The government's Coronavirus Job Retention Scheme (CJRS), operating initially for the period 1 March to 31 May, offers some relief.

Given the fall in time inputs, the firm could apply for the benefit for three months for a proportionate number of staff – depending on how the scheme is implemented this might save up to £0.1 million and £0.2 million cash per month in each scenario and improve average profit per partner by £10,000 and £20,000 per partner respectively.

However, as the fall in time inputs is expected to last six months and probably longer in some business areas, this approach needs to be weighed up carefully and compared to alternative voluntary, potentially more flexible, short time working with a commensurate temporary reduction in salary (which was used extensively by firms in the financial crisis) and voluntary and compulsory redundancy options. Our experience here in the financial crisis was that firms married up flexible working/unpaid sabbaticals and other measures with careful monitoring of utilization, both actual and prospective.

All these potential actions need to be considered in the context of:

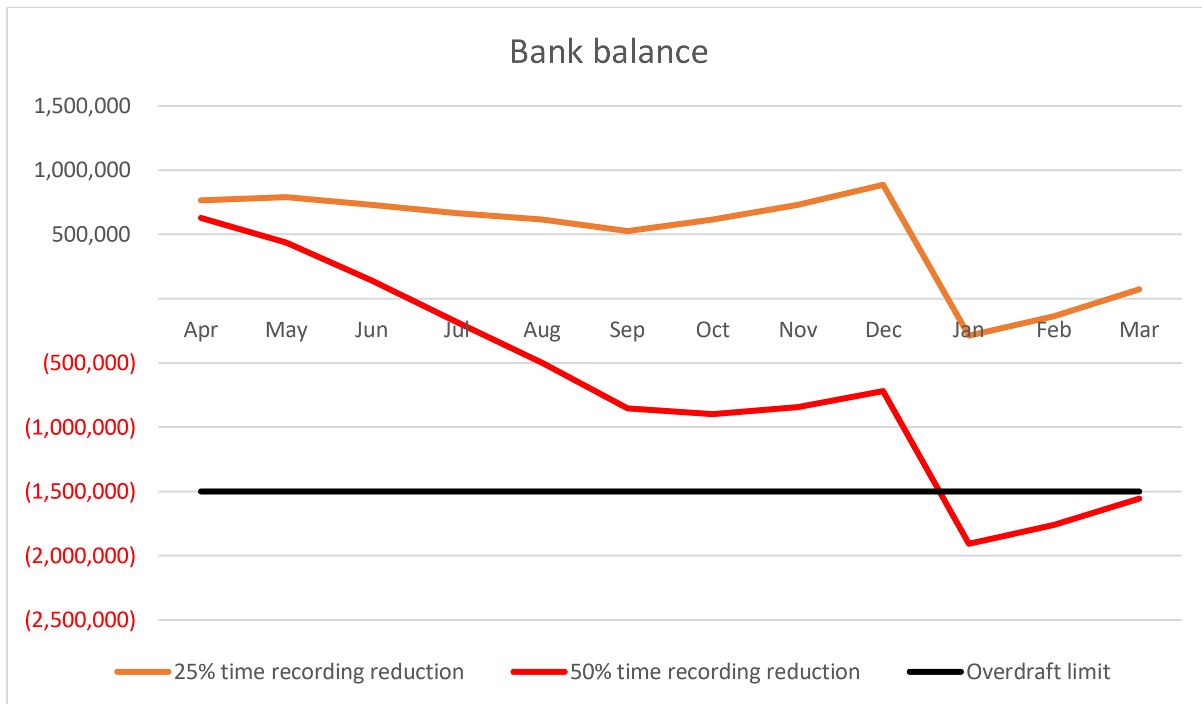
- the firm's culture and values; poorly communicated and implemented "right-sizing" actions are likely to have negative repercussions long after the immediate financial consequences have passed
- what level of profit partners agree is acceptable and the extent to which partners are prepared to set a good example by reducing monthly drawings (staff will want to know partners are "sharing the pain")
- the extent to which any cash flow shortfall caused by lower profitability can be funded
- visible leadership; your teams will be looking for visible, honest and clear leadership and transparent communication, including being honest about not knowing all the answers. If you do not fill the information vacuum, rumours will
- not stopping what you're doing to engage with clients

Cash flow

The extent to which the firm's cash flow requirements can be funded requires a careful analysis of the firm's monthly cash flow over this period. Fortunately, the government has offered two reliefs to mitigate any immediate cash flow pressures (deferring the next quarter's VAT until the end of the 2020/21 financial year and deferring July's income tax payment on account until 31 January 2021). Firms may already have sought temporary relief for the March rent payment (although this will be due in June).

In some cases, this may not be sufficient to remain within the firm's overall cash limits which may mean expense savings must be sought, partners' drawings need to be reduced or additional facilities sought. **If additional facilities are being sought banks will expect to see robust forecasts, rigorously stress tested.** This will also build the credibility of the firm's financial management should further facilities be needed to address challenges or take advantage of opportunities.

In our representative firm's case, its relatively healthy cash flow position at 31 March 2020 means the firm is forecast to breach its overdraft limit of £1.5 million in January 2021 only in the 50% reduction in time recording scenario but it will remain over its limit through 31 March 2021, as shown in the following graph:



Thus, our representative firm will need to consider the options outlined above, no doubt in the light of expectations for 2021/22 and beyond too, and determine its approach internally and externally carefully. Clearly the discretionary expense freezing and potential participation in the CJRS (and offering staff other flexible working options) will be sufficient to avoid breaching the firm's overdraft limit **but does that allow enough headroom in case things get worse?**

Conclusion

From this brief analysis of one firm using our model, it is clear that a properly structured and regular stress testing of a firm's forecasts will provide partners with the knowledge required to enable them to decide on options to secure a route through the current uncertainty. It also helps the firm to address and communicate effectively where sacrifices may need to be made for the long-term benefit of the firm. It also builds the credibility and authority of the leadership team as it gives a platform for calm, evidence-based review of the options – for example, if work levels have deteriorated markedly and are not expected to recover for some time.

This analysis is, of necessity, a simplified version of the firm's position but it does illustrate a range of considerations the leadership team needs to examine. For firms with a diverse range of practices, who will be affected in different ways, and firms who are more highly geared a more extensive analysis will be required. Furthermore, any firm that requires extensive external financial support through this crisis will have to plan its way out of its reliance on such support (which will require the firm to forecast at least three years forward where the range of outcomes will be even more uncertain). We recommend that firms take a realistic but conservative approach in carrying out this analysis – our experience of firms that undershoot their targets and have to adopt further measures is that this saps partners and staff morale.

We hope that this practical analysis provides a useful framework for your own stress testing. If you need any help with your stress testing using our financial model, please get in touch with us for a no obligation discussion. We would be delighted to help you.

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