

STRATEGY

Heed the warnings of financial distress

When the red flags go up, you have to act quickly to stem the losses and develop a workout strategy.

By Baker A. Smith

MORE THAN HALF the clients referred to my company, which specializes in managing turn-arounds, are family businesses. Often we are called upon when the business is already ill, when it is having trouble paying its bills. Before we can help plan a long-term recovery, we have to prevent the patient from bleeding to death.

But frequently there are warning signs—red flags in sales, finance, and operations that give the company some time to act before it is too late. Owners should know how to recognize them, so they have a fighting chance to stem losses and march smartly into the future.

The most ominous red flag is a decline in operating margins and a loss of working capital. Typically, a company's response is: "Let's sell our way out." The companies that turn to this strategy usually do so because it has worked in the past.

But when we examine these firms, we frequently discover that their sales forecasts are

overly optimistic and are rarely updated monthly by product category, branch office or plant, or sales territory. What is more, they may even lack a marketing plan. Given the lack of adequate data, the sales campaign is likely to falter and the crisis to worsen.

Closely tied to softness in the sales function is disarray in financial systems and controls. About 80 percent of our troubled clients have not received usable financial reports from their people on a timely basis or in an understandable format. As a result, management lacks information necessary to make crucial operating and marketing decisions.

Another red flag is the aging of accounts receivable, which reflects inattention to collections. Similarly, as cash shortages intensify and creditors clamor for payment, accounts payable become unmanageable. Suppliers refuse credit, materials run short, and production suffers from frequent interruptions.

A lack of purchasing and inventory controls can make the

materials and production problems even more acute. For example, at one company in the automotive after-market distribution business, the purchasing manager had for years been accustomed to "balancing inventory" for different items. The \$10 million company was in trouble but had received a credit overline of \$200,000 from its bank and a cash infusion from the sale of a piece of real estate. However, the purchasing manager insisted on putting the cash into slow-moving inventory in order to maintain "balance"—an unwise decision in view of the company's immediate revenue needs. We found it necessary to overhaul the inventory control system to avoid stock-outs and lost sales of high-velocity items.

In a financial crisis, a company desperately needs to control cash flow. But in severely trou-

In family companies, the storm clouds usually gather long before the financial crisis. Often the founder does not devote enough time to training the successors.

bled companies, cash controls are often missing. We find evidence of unreconciled bank balances, overdrafts, checks that have been issued but held in the financial manager's desk drawer. Such companies usually lack an adequate cost accounting system as well. As a result, their products may actually be priced below cost.

The existence of a good management information system, however, does not mean that a

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When too many people in the company are writing checks, we recommend that the "check-book" be centralized so that spending can be kept under control. We establish priorities for bill payments. Some expenses can be put off, but others cannot. Above all, the company must avoid writing bad checks, must be able to meet payroll, and must pay taxes when due.

Meanwhile, under the direction of the workout consultant, the company gathers information on its personnel and products, its competitors and market niche, its collateral base, its short-term cash flow and income projections, and the industry outlook. This information provides the basis for a recovery plan, which addresses systemic problems.

The typical plan will spell out what must be done to improve marketing and to streamline operations, what changes in management personnel and organization are needed, and how financial systems and controls can be improved. The plan can also discuss what additional capital may be needed after the company becomes stabilized.

Timing is critical to success. The moment to bring in a third-party turn-around and crisis consultant is when the red flags first appear. Emotional issues in the family business can sometimes delay this much-needed intervention. While the family remains unwilling to face the reality of the crisis, cash is drained and valuable time ticks away.

Quick action is essential to retaining a company's most precious asset—its people. During a crisis, the key middle managers may hear rumors about unpaid bills and delays in production and see signs of looming disaster; they may be receiving little accurate information from headquarters. The lack of leadership in such a company scares these people more than the financial problems. Unless a carefully thought-out recovery plan is put in place, the best people will be thinking of leaving—a potentially fatal loss.

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