



## Memorandum

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### **Dealing with Economic Turbulence** ***6 Steps to Stay on Track***

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The litany of economic problems facing businesses has been seemingly unabated since last year – the sub-prime crisis, the speculative boom and bust in commodities (including oil), a declining and volatile stock market, and a lack of credit availability. More recently, we have seen rising unemployment, a sharp decline in consumer sentiment with a bias toward saving rather than consumption, and negative GDP growth in the third quarter. All of these factors will likely result in the weakest holiday retail season in years and continuing economic weakness into 2009. Maintaining profitability, or in some cases viability and liquidity, under these circumstances is a difficult challenge for businesses.

To help weather the storm during this economic downturn, GBQ suggests managing your business with these 6 essentials in mind:

- 1 Monitor Cash**
- 2 Be Proactive: Take Fast and Decisive Action and Develop a Comprehensive Approach**
- 3 Prepare Targeted and Timely Reporting**
- 4 Know Your Lender, Creditors and Stakeholders**
- 5 Understand Your Fiduciary Duties to Creditors**
- 6 Get Outside Help**

#### **1: Monitor Cash**

It is possible that a company can still be reporting earnings but have trouble meeting its current obligations to both lenders and key creditors. Problems may develop as customers become slower to pay or, in some instances, don't pay at all. Problems may not be immediately recognized and could include changes in product/service demands, increasing overhead costs, use of obsolete production methods or increasing competition – some of these directly attributable to the poor economic climate and others already existing but more visible in this "down" economy. As a starting point, defer and/or eliminate all non-essential expenses and capital projects, where possible. Further, accelerate receivable collections: Focus on customers that normally pay on time and have started to slow payments; offer discounts to pay now; keep on top of even smaller accounts. Cash must be closely monitored on both a short- and long-term basis.



## **Short-Term Cash Flow Forecast**

*Prepare a 13-week cash flow forecast.* This is often an eye-opening exercise and will effectively capture most companies' business cycles. The forecast will help navigate choppy waters in the near-term, as it will highlight shortfalls in needed cash balances and/or show borrowing requirements that fall short of actual borrowing availability from lines of credit. This is a very popular tool used with distressed businesses and can be helpful for entities going through a rough patch or for stronger companies struggling in this economy. A cash flow forecast will force you to take a closer look at all expected receipts and disbursements on a weekly basis and compare it to actual results. This way you will know right away if there is a collection issue with customers that needs to be addressed or if expenses are too high against expectations. It will keep you abreast of how well the receivables are being collected on a short-term basis. In preparing the budget, be careful to select proper revenue assumptions (e.g., realistic sales, margins and/or receivable realization). Be conservative in projecting revenues and cash receipts. On the disbursement side, control over inventory procurement and subsequent payments can be critical, as it is often the largest cash expenditure. Also, be sure to identify non-income statement items (e.g., payment for capital expenditures, loan principal, capital lease principal obligations and/or interest) and nonrecurring items.

### **Factors to consider in developing a cash flow forecast include:**

- Significant increases in the inventory balance could mean a company has too much cash tied up in working capital and that sales are shrinking or the wrong mix of goods exists.
- A drop in historical inventory levels could indicate that a company lacks sufficient capital to procure goods required to run its business.
- Significant increase in accounts receivable, without a corresponding increase in sales, can be indicative of a company that is having difficulty collecting on its receivables.
- A drop in accounts receivable may be reflective of a drop in sales or demand for a company's goods/services.
- Significant increases in accounts payable can be an indicator that a company is having difficulty paying its trade obligations on time.
- An increase in the amount of debt used to leverage the business versus historical levels is a sign that a company may be unable to operate its business using operating cash flows.
- A decline in property, plant and equipment may indicate that a company has not been making the appropriate amount of capital expenditures to maintain expected sales or production levels or to keep up with competitors.
- Additional capital infusions (e.g., second lien loans, bridge loans, etc.), although not necessarily a sign of financial distress, may be indicative of a company that is experiencing liquidity issues or cash-flow problems.



### **Long-Term Business Plan (1-5 years)**

This plan, in addition to the cash flow statement, should also include a full income statement and balance sheet. Prepare this using a bottom-up approach. This means going to the divisional or cost-center level to derive estimates for revenue and expenses. For example, a business plan for a retailer should be derived on a store-by-store basis for both revenue and store expenses, and corporate overhead should be derived on a cost-center basis. In a manufacturing company, revenues and expenses should be estimated for each major product line. In all types of companies, the assumptions and initial estimates should be compared periodically against actual results to determine whether they are reasonable. In addition, outside influences should be addressed, such as the current economic environment, backlog of orders, discussions with buyers and customers, and whether trends are in line with the industry and competition.

### **Some additional items to think about when preparing a long-term business plan include:**

- What factors (internal or external) caused the financial problems, and are the temporary or permanent?
- What direction should this business take (e.g., grow, stabilize, sell off non-core assets, etc.)?
- What products/businesses are most profitable and which customers are more profitable to the company?
- What are the strengths and weaknesses of the company (e.g., management, markets, industry, competition, etc.)?
- What assets should be liquidated or expanded?
- What amount of funding is necessary to implement the business plan?

Preparation of sound business plans, both long- and short-term, can provide you with renewed confidence during times of economic stress.



## 2: Be Proactive: Take Fast and Decisive Action and Develop a Comprehensive Approach

The administrative and operational cost structure of all companies tends to grow disproportionately in good times, without a corresponding reduction when the economy and business volume slow. In order to maintain liquidity and manage debt, management must quickly determine core needs and shed excess costs. Take a look at the following items:

- Have expenses as a percentage of sales increased?
  - Is cost containment a necessity?
  - Have margins decreased?
  - Have variable and fixed costs been identified?
  - Are plant or profit center costs increasing?
  - Have corporate overhead or other general and administrative operating costs increased?
- Are expenses significantly out of line with projections, historical results, industry and/or competitors?
- Are there unprofitable customers that may need to be pruned or contracts renegotiated?
- Are there unprofitable product lines?
- Is there efficient inventory management?
- Is it time to consolidate facilities, make the business more scalable through outsourcing of functions, eliminate redundancies in operations and headcount, close selected store locations, or sell excess assets?

Consideration of closing unprofitable business lines/segments is daunting and counter to most entrepreneurs, but it will free up working capital to devote to more profitable areas, improve liquidity and/or reduce debt levels. Ultimately, this will reduce strain on the capital structure.

A comprehensive action plan and timeline will include, at a minimum, implementing a cost reduction program, improving inventory controls, enhancing purchasing procedures, accelerating cash flow and implementing cash retention. Today's business environment calls for fine tuning the entire business enterprise and making sure all the components work effectively together to maximize value.



### **3: Prepare Targeted and Timely Reporting**

Too often, businesses react to information two to three weeks after month-end. Effectively reacting to changes in this turbulent business environment requires timely information for revenue analysis, gross margin management, product line profitability analysis and administrative cost controls. With today's computer systems, most data can be collected and reported on a daily basis. The ability to have this information gives you the opportunity to create weekly comparisons to budgets. This allows management to react in real time to deteriorating earnings and unexpected market changes.

### **4: Know Your Lender, Creditors and Stakeholders**

Enterprise value is usually built up over decades. Declines in enterprise value are usually evidenced by deteriorating revenue and operating profit, impaired operating cash flow, limited liquidity on bank lines, and not having enough money to meet all the businesses needs. Sometimes the deterioration reflects shortfalls versus expected performance. In most instances, there is a lack of communication or shared expectations between the company and its external stakeholders.

As such, it is extremely important to be aware of who your main constituents are. Find a lender that understands your business and has a knowledge base in your industry. Keep in constant contact in good times and bad –surprises are never the way to go, especially given the current tightened credit environment and the potential difficulty of finding a new lender in today's economy. In addition, a complex debt structure, which may include first and second lien holders, can create hurdles when a company is negotiating a workout.

We also recommend constant communication with key suppliers and vendors. They may be willing to increase payment terms for special circumstances if they are aware in advance. Some industries are very small and many creditors know one another, so your company's financial misfortune may be common knowledge. It is always better that the company's story comes from you. In our experience, the most successful restructurings are completed when all creditors and lenders are part of the process and on board with the plan to move forward.

### **5: Understand Your Fiduciary Duties to Creditors**

Management and the board must be aware of their fiduciary duties to all stakeholders in the corporation, including creditors and shareholders. When a corporation has a deteriorating financial situation or is operating in the vicinity of insolvency, creditors may look to hold management and the board to higher standards with respect to their fiduciary duties. It is important, therefore, to keep this in mind and to plan appropriately.



## 6: Get Outside Help

Sometimes even following all these guidelines isn't enough and it's best to call in an expert to lend a hand. Skilled turnaround professionals like those in at GBQ or our alliance partner BDO Seidman, can look at your situation from an outside perspective and assess what changes are needed to adapt to the new business environment. Working together, you can gain a high-level understanding of the issues at hand and your options for dealing with them. But be sure to contact someone as soon as a critical situation is recognized. Waiting too long can mean that the time, money and patience needed to best address the issues at hand will be in short supply.

*Material discussed in this article is meant to provide general information and should not be acted upon without first obtaining professional advice appropriately tailored to your individual circumstances.*

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