1977

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Recommended Citation
Tempo, Vol. 23, no. 1 (1977), p. 49-51

LACK OF LIQUIDITY: THE EARLY WARNING SIGNALS

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In recent years, many companies have expanded at a mercurial rate, only to be hurled on the rocks by the rough seas of an economic climate.

Many of these companies drag down not only themselves, but their stockholders and creditors, and affect even the financial institutions which support them.

In most cases, the obvious cause of disaster is the company's loss of liquidity. The scenario in each case follows the same pattern. Operational problems cause an increase in current assets, which forces the need for increased debt. The financial institution reviews the financial statements and, based on traditional financial ratio analyses (tests of liquidity), furnishes the debt. Operational problems continue, current assets become no longer current, and the company defaults in debt payments. The financial institution again reviews the financial statements and determines that the company is no longer financially viable. There is a change in management, consultants are called in, turnaround plans are hurriedly prepared, and . . . the company fails.

Over and over, the final scene is the same. The real problems surface too late to be solved.

What are the early warning signs of a lack of liquidity? We suggest they are based on three premises:

First, liquidity, in a real and pragmatic sense, can no longer be viewed as a series of historical financial ratios; it must be viewed in a "forward looking" perspective.

Second, the traditional financial statement, viewed apart from operational analysis, is not an accurate and timely indicator of future viability. It merely reports the results of problems—too often after the problems have become too ingrained and difficult to correct.

Third, proper management and operational reviews, combined with astute information analysis, can do much to avoid disaster.

How To Define Liquidity

A general purpose of the balance sheet—in addition to showing how the business has invested its money in various assets, and the sources of such funds—is to indicate probable liquidity. In this traditional context, liquidity refers to the convertibility of assets into cash and the ability to meet creditor obligations as they mature.

The definition of liquidity, however, includes more than just the ability to convert assets into cash. We define liquidity as the ability:

— To maintain effective management control
— To sell the product in the future
— To convert future sales into cash
  Sales to profits (P&L)
  Profit to cash (B/S)
— To maintain the financial strength and credibility to ride out temporary problems that will occur.

Thus defined, one cannot wait for the traditional annual report to diagnose the financial health (liquidity) of the company. By the time such statements have indicated that a cancerous condition exists, the fatal disease can be too far advanced. Financial institutions as well as management, must rethink their traditional approach of measuring performance from only financial statement analyses.

Mature companies should never find themselves in the midst of a liquidity problem. Enough options are available to provide management with the opportunity either to fix the problem in its early stages or, if necessary, to liquidate or sell all or part of the company before its market value decreases significantly.

What safeguards are needed:

— Timely, accurate management reporting to identify problems early. (This assumes more than a set of financial statements. Key non-financial operating data is a must.)
— Astute management to respond to the warning signals revealed by proper management reporting, and to monitor progress against their plans.
— Adequate financial strength to withstand non-growth.
— Ongoing communication with financial institutions and suppliers, so that "they" can counsel management with the problems rather than be part of the problem.

Why do some companies find themselves in irreversible hard times? Because some miss the early warning signs, and so fail to achieve a turnaround. While others correctly read the signals, but are frozen into inaction by the enormity of the problems.

Still others react impulsively to the warning signals, slashing away at every expense. As a result, profitable and efficient programs are sacrificed, without identifying the real problems. Thus, a retailer who slashes payroll, merely buys time, because his real problem may be poor inventory control, poor site location, or a cash shortage stimulated by marginal credit sales. In one specific instance, a manufacturer who ordered a payroll slash by fifteen percent across the board caused havoc on his well-engineered production lines, leaving untouched excess costs in marketing.

Many companies who survive depressed economic times unscathed are just lucky. But many others succeed because they insist on sound planning, and then measuring their performance against that plan. The company which fails to measure its performance against its operating and financial plans, may do well in a growth market, but it is vulnerable to any downturn. Companies that wait for the audit report to indicate how viable they are generally end up identifying their problems too late to resolve them.

More important are the lessons to be learned from past experience. What can and should be done to avoid the "Illiquid Balance Sheet"?

The lessons are simple:

— Early warning is the first requirement for a successful turnaround.
— Financial statements report symptoms, not causes.
— Management and financial institutions must coordinate their efforts in order to maintain a company's credibility.

There are three basic areas in which companies and their lenders can work together to try to assure liquidity:

— Management and operations review
— Improved information analysis (early warning signals)
— Non-crisis problem solving.

Management and Operations Review

A management and operations review can provide management and its creditors with an objective identification of a company's strengths and weaknesses. It helps focus more clearly on the critical performance indicators. It is in two phases: 1) a review of the business and its management and 2) potential problem identification.

The thrust of the review is to assess the degree of management control in the enterprise. Effective control requires that an enterprise 1) have the structure and resources to identify potential sales, as well as production, financial, and marketplace problems, and 2) take positive action before potential problems become crisis problems in the financial statement. To evaluate control, one analyzes management's resources, organization structure, information flow, planning processes, and the marketplace in which the firm operates.

Improved Information Analysis

Periodic management and operations reviews are of limited use without an "early warning system" that will analyze potential problems. To identify such problems requires improved information analysis. Such analysis includes monitoring trends, challenging performance, asking hard questions, and insisting on results.

The financial community, as well as management, has been using ratios as a major analytical tool. But traditional balance sheet ratios and earning ratios, we have seen, serve only as a benchmark; they fall short as an effective means of monitoring a company.

In fact, not only does traditional financial statement analysis suffer from being untimely, it can also be misleading, analogous to "the calm before the storm." For example, adequate working capital might actually reflect some problems. The high inventories are the result of soft sales, not record production. High receivables are caused by customer dissatisfaction and poor quality, not heavy sales. Low payables are because of supplier C.O.D. requests, not ability to make payment. And adequate cash exists because very little of it is needed for future growth.

The solution lies in analyzing performance trends that compare unfavorably with the past or with plan, and then creating a feedback mechanism to indicate the response, if any, management has made and the anticipated results.

The following type of information should be analyzed, in addition to traditional financial ratio analysis:

Ability to sell the product.
Is the product needed? Will customers stockpile it? How long is its effective life? Who are the customers, their economic status, their location? Are raw materials available, and are suppliers reliable? How many unit sales are anticipated? What is the market share? Is there a backlog?

Ability to convert sales to earnings.
Can the plant's efficiency and productivity maintain gross margins? Can increased costs be passed through? Are expenses being controlled, both planned and indirect? What is the breakeven volume? Are production levels and profits headed in the right direction? What are the labor and overhead, the ratio of direct to indirect labor? Are materials being used efficiently? Do current value accounting concepts accurately measure the quality of earnings?

Ability to convert earnings to cash.
In managing accounts receivable, what are the credit policies, the comparative age of outstanding accounts? How are inventories controlled? What is the turnover, particularly on finished goods, the production backlogs, the raw material shortages? How are accounts payable managed, the age of payments due?

Whether additional analysis is required will depend on company circumstances. For example, if the management and operations review identifies productivity as a potential problem, then information should be requested to compare a production output with labor costs. If the review reveals a weakness in sales and marketing management, pricing and sales mix should be analyzed. Sales per square foot help define the productivity of a multi-store retailer, but do not tell much about a steel mill.

The men who are engaged in running the Federal Reserve System were handed this act as a printed document . . . and told to open Federal Reserve Banks in 16 days; and from that time on, with a great war raging, we were expected to construct out of thin air something that had not existed for over 80 years. And I am frank to say that we knew mightily little about it.

—BENJAMIN STRONG

The analyses compare year-to-year operating performance with both prior years and current objectives. *Any changes from the norm constitute the early warning signs which traditional approaches tend to overlook.*

Non-Crisis Problem Solving

Conducting management and operations reviews and using early warning signals do not guarantee that problems will never arise. They do, however, provide the basis for more rational problem solving.

Once some early warning signs are spotted, what action should be taken?

Non-crisis problem solving involves a five-stage response that maintains the company's viability, consistent with its longer range objectives.

■ Stages 1 and 2 are *planning* steps which are, in effect, the management and operations review.

First, assess the organization, control, and management resources, availability of performance data, and vital external factors, such as industry trends and vendor and customer relations.

Second, focus on more detailed financial and management information and operations analyses. Determine the likelihood of correcting the situation, and what the general requirements are to do so.

■ Stages 3 and 4 are *action* steps.

Third, analyze the profit centers and cost centers that obviously need to be improved. This can include organization, product line, pricing, and overhead analyses.

Fourth, recommend management action that requires specific objectives and target dates. Often managers assume that once a problem is identified, the job is done.

■ Stage 5 *measures results.*

Develop the tools needed to make the improvements occur; measure actual progress against the action plan.

What factors will tip the scales in the company's favor when implementing an early warning system?

— The speed with which the condition is identified.
— The perimeter of the problem.
— Resources management needs to combat the problem.
— Management's ability to make a hard decision—i.e., against a pet product line, or a non-productive in-law.
— The degree of cooperation between management, financial institutions, vendors, and professional support (lawyers, accountants, consultants).

The Final Message

In the life cycle of every company, *there will be* recession, inflation, technological change, and irrational competition. It is, therefore, inexcusable for a well-managed company or financial institution to be caught by surprise.

We believe that the concepts discussed here are generally applicable to all organizations: manufacturers, retailers, service oriented concerns, hospitals, and municipalities. The approach is also well suited to the lender/creditor relationship.

The message we leave with management is that financial ratio analysis is an appropriate exercise for management but that it is not a substitute for an early warning system for identifying operational problems. No manager should be reluctant to go to his financial institution and seek insights into solving his problems. Indeed, enlightened management not only should look to financial institutions to challenge performance, but also may interpret their silence as a sign that things are going well.

The message to financial institutions is that a company with financial problems did not acquire them overnight. It has usually experienced one to three years of subsurface difficulty. The earlier these signs are identified and analyzed, the greater is the chance of effective corrective action. In brief, financial institutions should use the following as their guide:

1. Insist that customers use early warning techniques, have periodic operations and management reviews.
2. When in doubt about trends, ask hard questions and insist on results.
3. If results do not occur quickly enough, do not hesitate to call for help from outside the company. △