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Providing Help for the Company in Trouble

William E. Arnstein

Ray W. Cheesman

Companies in financial trouble often seek outside help, either from their auditor or from a management consultant affiliated with their CPA firm or independent. What are the guideposts to choosing the right adviser?

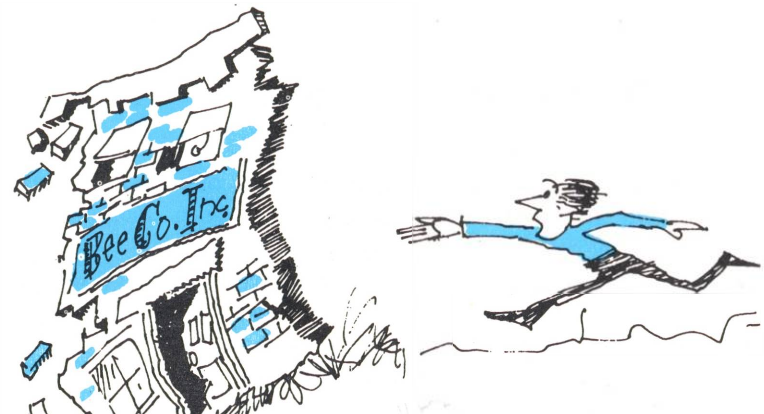
PROVIDING HELP FOR THE COMPANY IN TROUBLE

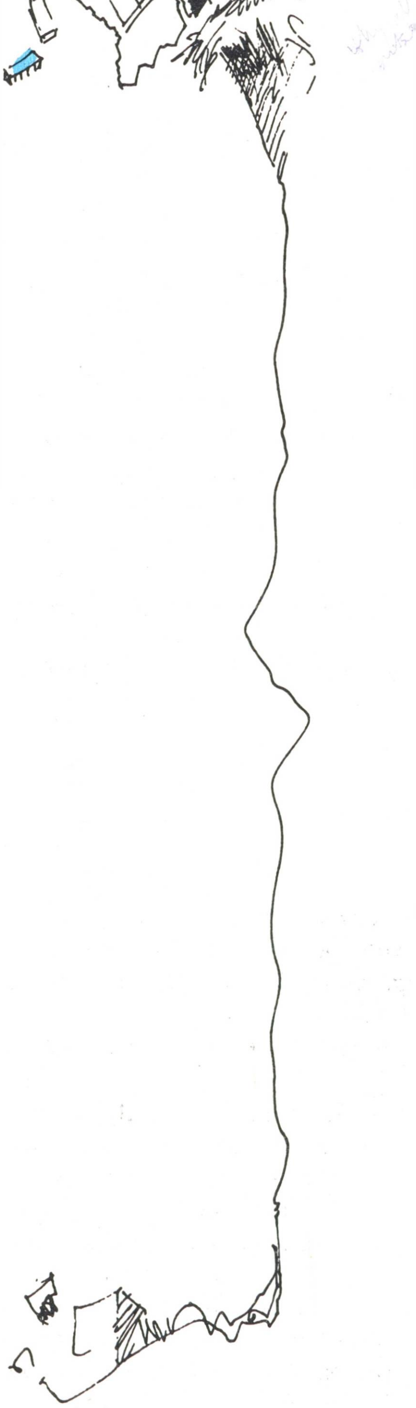
by William E. Arnstein and Ray W. Cheesman
Main Lafrentz & Company

EVERY year a large number of well established companies with long and successful histories find themselves with declining profits, losses, or a cash squeeze. Quite a few of these companies end up in bankruptcy. Needless to say, each company's management has done all it could to bring the company back to profitability but still the result has been a costly receivership followed all too often by a liquidation which wipes out the investment and leaves many creditors only partially protected. Often the human tragedy of lost jobs and lost opportunities exceeds the financial waste.

Could an outsider have helped turn the company around? In most cases the answer is "Yes" if the outsider is called in early enough and if he is sufficiently knowledgeable and experienced. Then why doesn't every troubled company take advantage of this possibility? Too often management will blame a series of losses on specifics: three years ago our sales manager was out ill for six weeks; two years ago the paint on our product was defective and caused a lot of returns; last year our production of one product was held up for a month while a machine was being repaired; etc., etc. Management assumes no bad luck will occur this year so there is really no problem. Realistic managements know that operations should be planned to show respectable profits at year end despite a little hard luck. Unfortunately, some hard luck normally characterizes every year.

Even when management recognizes that the company is in trouble it does not always call in outsiders. The president is human enough to believe that if he thinks a little longer or a little harder he can resolve the difficulty. Or he calls his executives together and they jointly seek a solution. After all, the president tells himself,




Even the well-established company with a successful history can find itself in trouble, even in bankruptcy.

these men reached their present high positions through proven ability and certainly no outsider can possibly know as much about the business as they do. This point of view is faulty in several respects. The company's management is usually too close to the day-to-day problems to be able to detach itself sufficiently to see the broad picture. In many instances, individual executives will think in terms of the need to justify their past performance rather than in terms of the requirement to set a new course. Certainly, an executive will be reluctant to attach a "mistake" label to a decision he fought for only a month ago. He may be almost equally reluctant to criticize the performance of a fellow executive of whom he is fond.

An outsider can bring to the study a fresh outlook with no investment in past decisions and no ties to individuals. In addition, he brings a broad knowledge of how other industries operate and considerable experience in dealing with changing situations. A company facing a crisis can ill afford to overlook the potential contribution such an outsider can make.

The CPA's role

Since it is recognized that many companies will not call in outsiders on their own initiative, the company's independent accountants should consider suggesting that an outside survey should be made. In many cases, the accountants have a perspective which will cause them to perceive the seriousness of the problem before management recognizes that the trend cannot be explained away in terms of a few specific nonrecurring events. In many cases, the independent accounting firm is in a position to make the necessary study itself. Yet, relatively few accountants will suggest that they be employed for such an assignment.

The reasons that independent accountants rarely offer their services are several but none are very good in the writers' opinion. Firstly, they may fear the client will consider that they are merely trying to make a profit at the client's expense. Secondly, they may fear that the company will be unable to pay the bill and, accordingly, their time would be more profitably spent on routine assignments for financially sound clients. Lastly, they may wonder if the providing of fundamental operating recommendations will impair their audit independence.

Of course the client may react that the whole purpose of the suggestion is to provide a profit for the accounting firm. But this reaction is true of any effort on the part of the provider of a service to explain the merits of his services. If the assignment is properly presented and is successful, the client will be properly grateful —in fact very grateful. If the assignment is unsuccessful, the accounting firm has no one but itself to blame.

It is true that financially troubled companies pay for professional services more slowly and less surely than other clients. However, the long-range benefit to an accounting firm in saving clients can hardly be underestimated. Not only does the firm retain a live client for auditing for many years in the future, but a client that has been saved is hardly likely to switch auditors because of finding a pleasant golfing companion from another firm.

As to independence, the outsider's help should always be in terms of advice and technical assistance. Management decisions should be left to the company's management. No other approach is sound or practicable and this approach does not affect audit independence.

There will be instances in which the accounting firm is not qualified to advise management. Before accepting an assignment which may mean the difference between prosperity and bankruptcy for a client, the accounting firm should carefully consider its competence in this type of work and particularly whether it has sufficient prior experience in this type of problem. Knowledge of the industry is very important. At this point a conscientious accountant may well disqualify himself and his firm. In these cases its obligation is still to suggest an outsider but the suggestion will be that another firm be used, either a larger CPA firm, a broad range management consulting firm, or a management consulting firm specializing in a particular industry, problem, or technique.

Avoiding a common error

Many companies regard their accounting firm and, more particularly, the partner in charge of their audit as a business adviser. When the company has had some months of unsatisfactory profits and the president meets with the audit partner, an interchange of ideas often takes place. A common occasion for such an interchange might be when the annual financial statements are delivered and both parties realize just how bad the situation really is. If during this conversation, the two men explore the problem for an hour or two each may leave the meeting feeling that something worthwhile has been accomplished. Usually it hasn't. The president's use of the accounting firm's partner as a sounding board has merely reinforced his pre-conceived ideas with no chance for the outsider to provide independently developed data which might indicate that the problem was entirely different from the one seen by the president.

This is the time for the accountant to propose a study in depth to determine what is really wrong with the company's operations. Is it in marketing, production, planning, or financing? Are the president's complaints based on facts or on impressions arising from a few isolated instances? It is very unlikely that the company's ills can be cured without an intensive study which will ordinarily include the gathering of considerable information from outside the company.

Selection of the right man

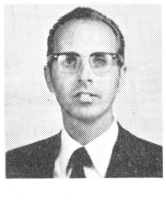
If the company accepts the recommendation for a comprehensive survey, the audit partner will decide what type of man with what background should be assigned to do the work. In some accounting firms the audit partner will himself conduct the survey. He may assign certain analysis work to other audit personnel and the highly technical aspects of the study to specialized management advisory services personnel. In other firms, the responsibility for such an assignment is given to a generalist in management advisory services who, however, works very closely with the audit partner. Depending on the skills and experience of the individuals involved, either plan may produce good results. In order to consider the best approach, the contribution which is most likely to come from each will be considered.

The auditor as consultant

The one person who usually knows more about a company's business than anyone else outside the company is the audit partner who is responsible for the annual examination of the financial statements. As a result of his participation in the annual audit over a number of years, he has developed a thorough understanding of the company and its business. He has acquired a general knowledge of the industry as well as a more detailed knowledge of the specific business of the company. Through periodic discussions with management concerning audit and tax matters, the audit partner is generally familiar with the company's objectives. As a result of his past association, the audit partner will undoubtedly receive greater cooperation from company personnel than any other outsider.

His knowledge of key personnel below the top management level and their responsibilities, enables him to develop necessary information without wasting time. In dealing with these people, he can quickly evaluate the information received and he can separate the personal gripes from the construc-

WILLIAM E. ARNSTEIN, CPA, is a partner of Main Lafrentz & Co., New York. He is on the panel of advisers of this magazine's "Management Advisory Services Forum." Mr. Arnstein is the author of **Management Services by Accounting Firms**, Ronald Press, 1967. He is presently on the AICPA's Economic Stabilization committee and the committee for liaison with the Cost Accounting Standards Board. Formerly, he was on the management services committee.



RAY W. CHEESMAN, CPA, is a partner of Main Lafrentz & Co., New York. He is a member of the New York State Society of CPA's committee on insolvency and bankruptcy. In addition, he is a member of the AICPA. Since 1968, Mr. Cheesman has performed special investigations for the government of Liberia with respect to its major concessionaires.

tive ideas. He is also aware of certain characteristics of top management personnel including the philosophy and approach, experience, and performance. Such information enables him to determine which of the possible solutions will most likely be acceptable to management. An important part of the annual audit is the study and evaluation of the company's system of internal control primarily for the purpose of determining the nature, timing, and extent of the audit procedures to be applied. While fulfillment of this purpose is a professional requirement, the review also enables the audit partner to develop constructive suggestions for improving control, and therefore increasing efficiency or otherwise improving profitability. As a result of the review of the system of internal control, the audit partner is familiar with the accounting system employed and the controls which are part of that system. Since he is already familiar with the company's activities and its accounting system, he does not have to spend valuable time to develop this information. Since he knows what records are maintained by the company, he can quickly locate information required to prepare analyses and he won't be told it isn't available when it is.

An audit partner, especially one who has not specialized in a single industry, generally has had many years of experience involving a wide range of business activities; therefore, he has developed an overall business perspective. This experience, along with continuing education programs, both within his firm and outside, provide the audit partner with a thorough understanding of the complex functions of modern business management including planning, organizing, coordinating, and controlling.

Effective financial management of cash and related short-term investments and of debt is important to the success of every business venture. The lack of competent management of this area is a frequent contributor to business failure. Small business is especially vulnerable when management lacks financial sophistication, and fails to appreciate the difference between reported profits and cash flow. Because of his training and experience, the audit partner is particularly capable of reviewing the financial function of the company. He is well aware of the long-term and short-term considerations of cash management. Over a long period he considers the relationship between cash requirements for debt repayment and internal growth and cash flow from operations. Adequacy of working capital must also be reviewed. Short-term considerations include the maintenance of adequate daily cash balances to provide for smooth operations and the investment of temporary excess cash for maximum profitability. The audit partner can prepare budgets and cash flow projections.

The projections will enable the company to see if its planned improvements are practical in terms of its needs to meet payrolls, continue to purchase materials and merchandise, and meet its commitments to banks and other creditors. The audit partner is not likely to recommend a program which would assure substantial profits five years from now if the program spells bankruptcy three months from now. The audit partner can assist in the preparation of information on past operations and he can assist in the preparation of a forecast of future operations acceptable to banks and other lending institutions. This in-

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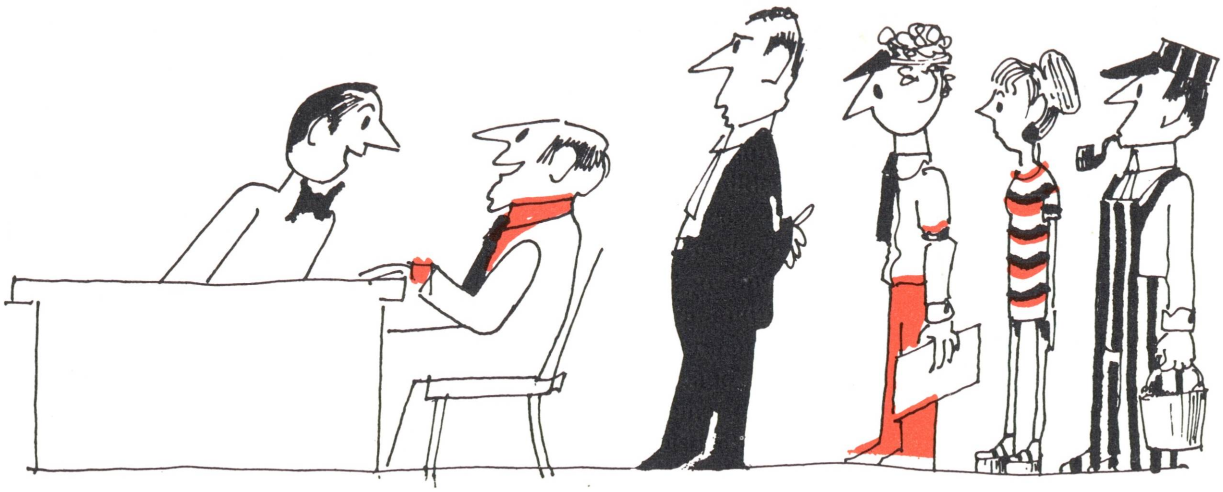


The MAS specialist, on the other hand, is likely to start by interviewing workers of every rank, beginning with the company's executives.

formation should include results of operations as well as cash flows.

Since the salvation of many companies in trouble depends on being able to borrow funds or renew loans, guidance by the audit partner in the preparation of information for submission to banks may be extremely important. In somewhat different circumstances, a troubled company's future may depend on its ability to go public. The audit partner should be quite helpful in advising management with respect to public offerings of its securities.

Today, more than ever before, tax considerations play an important role in many management decisions. Because of his training, the audit partner can, without extended research, evaluate the tax consequences of management's proposed decisions. Certainly he will not overlook the tax angles of any recommendations he might make. If a privately held company plans to improve its cash position by further support by its owners, the audit partner can advise the owners on the best method of putting in the cash from the viewpoint of tax considerations and estate planning for the individuals.

It is also likely that the audit partner will be quite fee conscious. His long association with the client will cause him to make every effort to keep the charges for this special work at a minimum in view of the critical financial condition of the client.

The MAS generalist

In the usual case, the firm's MAS generalist will have had no previous contact with the client and therefore starts with no preconceived ideas. He ordinarily begins his work by interviewing the company's top executives to obtain their views as to what caused the situation and what can be done about it.

However, he regards this as only a first step and a very inconclusive one. Too often the company's executives sincerely believe certain things are so when they are not. A recent customer's complaint may cause the sales manager to believe deliveries are often late when an analysis may reveal this complaint reflects a very rare occurrence. The production manager may feel that maintenance is sloppy when the reverse is true. The controller may be worried about collections because his interest in them has been intensified since the crisis developed, but an analysis may show that they are as good as they have ever been. On the other hand, a deep look into the figures may show deterioration in product mix, sales returns, or idle time which had escaped the notice of the executives. Often an outsider will ask why a certain thing is being done a certain way and will be told, "It has always been done that way," or "We don't know any other way to do it."

Since the MAS man has been called in as a professional, he will not be tempted to stop his investigation until he has done as much work as appears productive. Superficial answers which might come from his acting as a sounding board for management will not satisfy him. Since he regards his study as a distinct and separate assignment, the work planned will relate to the reasonableness of a fee for such an assignment and he will not tailor his work with the idea of keeping the charges so low that they can be absorbed in a small increase in the audit fee.

The MAS man is likely to be industry-oriented as opposed to being company-oriented. On most broad based assignments, he will seek information on how other executives in the industry operate either through cross-examining the company's executives on their knowledge on this point or through personal contacts. Frequently, he will seek information from editors of trade papers or trade association executives. He will certainly review any industry statistics which are available from government or other sources. This approach, at worst, improves his perspective and, at best, may provide all or part of the solution to the company's problem. Although any outsider is less likely than an insider to be protective of individuals within the management, the MAS man in most cases has had no previous contact with the client's executives and therefore has no personal loyalties.

The MAS man is more interested in the income statement than in the balance sheet. In most, but not all, companies in trouble, the strengthening of the balance sheet is a temporary expedient which will not guarantee a permanent solution. The MAS man will ordinarily look beyond the next fiscal year end. He will recognize the need to show improvement by the next loan renewal date but he regards this objective as only a first step, not a complete solution to the problem. The MAS man is interested in marketing effectiveness, production efficiency, and warehousing and distribution costs. He has experience and education in these areas. When he looks at marketing he is more concerned with a sales decline than with the consequent increase in selling expense percentage. He will emphasize those aspects of the investigation which might reverse the unfavorable sales trend even if the recommendations produce an increase in selling costs in dollars and as a percentage of sales. He may even suggest price cuts to bring up volume because the resulting volume increase will provide a higher dollar contribution towards meeting fixed costs. These price cuts might even bring the selling price of some products below full costs and will certainly hurt operating ratios. However, they may save the company.

The MAS man is more interested in the income statement than in the balance sheet. In most, but not all, companies in trouble, the strengthening of the balance sheet is a temporary expedient which will not guarantee a permanent solution.

Similarly, the MAS man will concern himself with production costs in a manufacturing company and operating costs in any company. Again, he is more concerned with the actual methods of operation and the potential for savings than with comparisons with past periods or with budgets. The past period may reflect inefficiencies and so may the budget. He goes into the plant or operating area and seeks better methods whether these be in production, operations, material handling, or product design. He will undoubtedly tour the plant and in doing so get a pretty good idea as to whether the workers' efforts are above or below average. Where warehousing and transportation costs are significant, the MAS man will consider whether these can be cut. The fact that such costs are often buried in the selling expense account may mean they have not been given proper attention in the past, particularly if the marketing management is completely sales-oriented. Although a study of the traffic department can frequently pay off, a more likely approach is the reduction of small orders by pricing differentials and the elimination of emergency shipments by improved production scheduling procedures.

The MAS man will realize that the efficiency and accuracy of office procedures are important but that it is unlikely that this area will be the most fruitful in terms of turning a loss operation into a profitmaker.

Services offered by the MAS man

When an MAS man accepts an assignment to look into a troubled company, he usually is in a position to devote full time to the job until it is completed. The writers once knew an MAS man whose prescription for every troubled client was to "increase sales, improve gross profit percentage, and reduce costs"; however, he never said how this was to be done. Fortunately, few MAS men operate this way. In fact, a major advantage of the MAS approach is that it stresses the "how" to arrive at the "what to do." A client who follows an admonition to reduce inventories, cut expenses, or watch bad debts without recognizing that there is a right way and a wrong way to do each of these, can do itself more harm than good. How is it possible to follow logical advice and get into trouble? Examples from the writers' experience may be helpful. One client observed a rise in raw materials and work-in-process inventories during a sales decline. He instructed purchasing to suspend operations until inventories came into line. However to be converted into finished goods, most of the raw materials and work-in-process required parts not yet on order. Results were that shipments virtually dried up and inventories rose further as materials previously on order were delivered. Another client was told his indirect labor costs were too high and a study should be made as to where they could be cut. He decided to forego the study but laid off ten per cent of the indirect labor in every department. This was too much in some departments and not enough in others. Those departments which could not operate on the reduced staff caused chaos. Eventually, many of the laid-off men had to be replaced, in many cases with a high cost of training and the waste caused by untrained personnel during the interim.

In the final example, a credit manager was criticized for his bad debt losses. He tightened his credit policy to the point where so many orders were being rejected that the loss of gross profit greatly outweighed the savings in bad debts. This unfortunate decision had the additional disadvantage of discouraging the salesmen whose orders were being turned away.

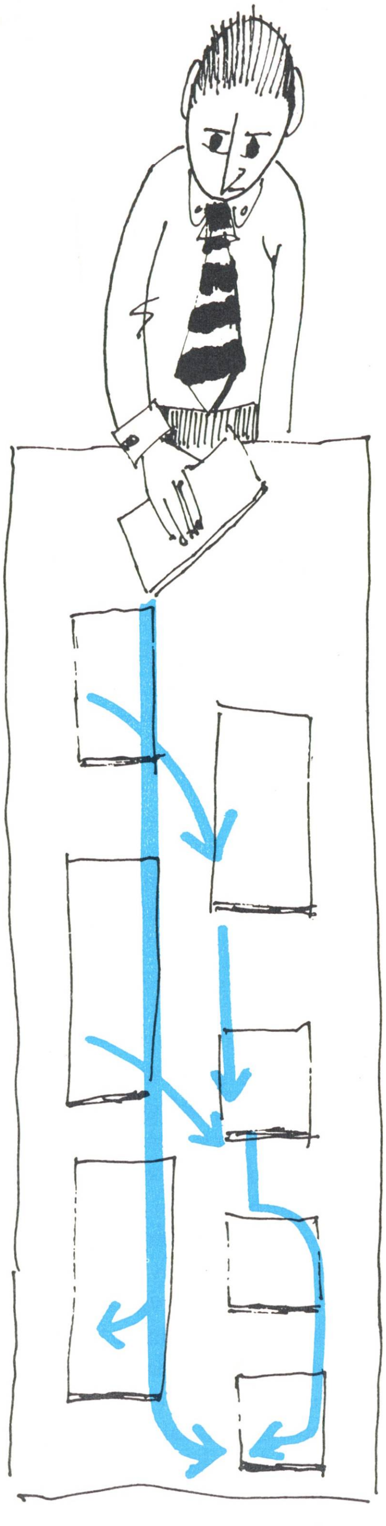
The MAS man will not only advise the client on the specific techniques which apply in his case but will often offer his services to help the client carry out the program. For example, if the major profit decline has been caused by loss of customers due to missed delivery dates, the MAS man can design a system of production planning and scheduling and help to install it. If it appears profits have been lost through the sale of unprofitable products, the MAS man can estimate the cost of each product to determine which are below average profitability and, more important, which have variable (out-of-pocket) cost above or so close to the selling price that they provide no contribution toward fixed costs.

The MAS man can study sales territories to determine reasonable quotas for salesmen. In other instances, he can design and implement an inventory management system which will serve the dual purpose of generating cash through inventory reductions and improving customer service by having wanted items rather than overstocks of slow moving items. Finally, almost all MAS men have the ability to design management reporting systems which will aid management in its decision making. None of the foregoing implies that every MAS man can do all of these things. On the contrary, one of the advantages of the MAS man's approach is that he recognizes the need for particular expertise in some of these areas. When it appears that a specialist's services are required, he is most apt to realize the requirement and call for the right man to take over that part of the job.

At this point, it should perhaps be mentioned that the function of any outsider, whether it be the MAS man or another, is to advise management and give it technical assistance. Only management can properly run its business. History is replete with instances of consultants taking over the operations of troubled companies usually with dire results, though there have been a few notable exceptions.

Conclusion

A company in trouble has little to lose and much to gain by calling in an outsider. In many instances, the best consultant available will be found in the company's independent accounting firm. The company's audit partner and the MAS staff of the firm each has much to contribute and they will work together for the greatest benefit to the client. The suggestion for a survey in depth can properly originate with either the client or the accounting firm. The important point is that the study be undertaken in time.



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