Finance is everything: advice from turnaround managers

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There are many reasons why companies drift – or plunge – into financial disaster. Factors such as market share loss, excess debt, management problems, and technology changes can all play important roles. In fact, the number of risks facing corporate offices is enormous and simply keeping abreast of it all is a colossal task. As a result, not all managers and firms can cope. The typical recommendation would call for a turnaround strategy, but the academic and professional literature on turnarounds leaves many unanswered questions. In particular, what sets successful turnarounds apart from failures? Our research and experience in the field suggest that the most frequent underlying causes of the problems faced by companies in turnaround situations are relatively straightforward – as are the solutions. And they are related directly or indirectly to management. Like sports teams on losing streaks, management's troubles often begin with the neglect of the fundamentals.

What follows are what we consider ten ''back to basics'' management practices derived from turnaround management. These, we suggest, are what managers must focus on. Managers who have incorporated these basics into their organizations have not only helped their firms or divisions survive but have consequently remained healthy.

Understanding financials

> Joseph Elder's corporation manufactures and distributes athletic gear. A few years ago, as the company reached $2 million in sales, it experienced a severe cash flow shortage. Mr. Elder's agreement with the bank supplied him with cash up to 75 percent of his accounts receivable. In his preoccupation with business development, he was unaware that his profits were insufficient to finance the remaining 25 percent of this asset.

Most managers have a good understanding of their income statements. Approximately two-thirds, however, have a poor understanding of their balance sheets and the implications. Mr. Elder was surprised to find out that for every dollar increase in receivables, he would have to find 25 cents financing elsewhere. The bank would provide only 75 cents on that dollar.

Most entrepreneurs and managers come from diverse sets of educational and experiential backgrounds. As intelligent and knowledgeable as they are, many lack the needed practical tools and techniques of business – especially tools for risk analysis. At minimum, managers at all levels of business should have a working knowledge of basic quantitative tools. This includes break-even analysis; financial ratios and ratio analysis (including operating and financial leverage concepts); EBIT-EPS analysis; capital budgeting; Altman's Z score; variance analysis; beta; sensitivity and scenario analyses; and the five Cs of credit and other credit scoring techniques.

Underscore the cost of capital

Edward Jamison, CEO of a company providing maintenance services to large companies in a major US city, was having difficulties with his banker. With few exceptions, he had always been profitable, but his profit margins were razor thin. ''We're in the black and that's what the bottom line is all about.'' He understood his income statement, but did not appreciate the fact that it does not account for all types of financial costs, especially risk.

From a financial standpoint, firms can become candidates for turnaround management when they cannot cover all their costs, including:

- *Risk*. Risk is a cost requiring a premium paid to investors to offset it. It is uncertain, like a coin flip with a loaded coin. It is a real cost – but it is not on the income statement except as an unnamed residual part of profit.
- *Liquidity preference*. Investors prefer liquidity to investing immediately in the event a better investment opportunity comes along. Hence, a premium is required to get investors to part with cash, even for a riskless investment. But a ''liquidity preference'' cost is nowhere to be found on an income statement.
- *Inflation*. Present dollars buy more than future dollars because of inflation. However, that fact does not appear on income statements.

Unless profits are large enough to cover all of the costs associated with the use of capital, firms or divisions are actually in a loss position.

Significance of cash flow

Profit margins are fundamental, but all too often asset needs have a tendency to outpace the firm's ability to finance them. Table I demonstrates how easily this can happen.

In the balance sheet shown in Table I, operating cash is that inventory of cash, both in the bank and on hand, which is absolutely essential to ensure that the company checkbook is not overdrawn. Excess cash is cumulative cash flow, and Table I demonstrates that cumulative cash flow and cash flow itself depend on the need for working capital and net fixed assets – not just profit. By the second quarter, this company was in serious difficulty – although its profits more than covered its 15 percent cost of capital. Sometimes even turnaround managers and researchers fail to acknowledge the significance of cash flow (Stover, 2003). That the cost of capital or cash flow may escape the scrutiny of the manager also points towards the necessity of having the appropriate information.

Table I General corporation proforma financials (USD 000,000)

Income statement	*Quarter 1*	*Quarter 2*	*Quarter 3*	*Quarter 4*
Sales	100.0	110.0	120.0	130.0
All costs	(92.0)	(101.2)	(110.4)	(119.6)
Profit after taxes (net income)	8.0	8.8	9.6	10.4
Balance-sheet				
Assets				
Excess cash	4.7	(12.1)	(23.0)	(28.1)
Operating cash	12.0	13.2	14.4	15.6
Accounts receivable	33.3	36.7	40.0	43.3
Inventory	40.0	44.0	48.0	52.0
Total current assets	90.0	81.8	79.4	82.8
Net fixed assets	50.0	65.0	75.0	80.0
Total assets	140.0	146.8	154.4	162.8
Liabilities and equity				
Current payables	10.0	11.0	12.0	13.0
Long-term debt	30.0	27.0	24.0	21.0
Equity (net worth)	100.0	108.8	118.4	128.8
Total liabilities and equity	140.0	146.8	154.4	162.8

> “ **Managers easily miss the signs of impending crisis when their information is incomplete.** ”

Data and information

A controller at a large software company called his former professor, one of the authors, a few years ago to ask for help understanding methods of profitability measurement. The controller was working with the general manager of a troubled division who had no idea what his assets were and had concluded that a return on assets measure was not relevant. Records were poor and some assets were shared with other divisions. Against the advice of the author, they decided upon a profit-to-sales measure. The division was liquidated a year later.

In many cases where a turnaround situation is warranted, turnaround managers typically encounter data that are incomplete, untimely, in error, or otherwise misleading. The data were so bad at WorldCom when Robert Blakely stepped in as CFO in 2003 that the financial statements from 2000 to 2002 had to be completely reconstructed. The task took months, and at one time there were 1,500 people involved in the restatement (McCafferty, 2004).

Correct data alone are not sufficient; that data must be converted into information relevant to the decisions management must make. The usual objective, even at the divisional level, should be to obtain a return on equity equal to or greater than the cost of capital.

The software manager in the vignette above had to be able to translate his data into information – return on investment and return on equity – to know whether his division was performing at an acceptable level. To develop this information the manager needed to know the value of his assets and understand how much debt the division could bear. Managers easily miss the signs of impending crisis when their information is incomplete.

Denial

James Ross' welcoming smile disappeared quickly as he got to the point in our first meeting. His company had lost money over the last 12 months. Three days previously, Mr Ross's banker had given him 90 days to repay his receivables loan and get out of the bank. ''I know I'm in a cash crunch now, but it's temporary. I only need a small increase in my loan and a little time to get out of it. My banker doesn't understand this. Maybe you can help me by convincing him that things will get back to normal after I get over this hump.'' This story is a typical case of denial. Mr Ross needed to believe that things would get better on their own, so he exaggerated good news and ignored the bad. He was convinced that an increase in sales volume was right around the corner, but had no evidence to support his belief.

Mr Ross' problem was not the lack of cash, although cash limitations are almost always a symptom of something deeper. In this case, it was cost control; and deep down he knew it. He as much as said so in the sessions that followed. If he had admitted it to himself, however, he would have had to admit it to others in his organization. Worse yet, he would have had to take steps to remedy the situation. It took a crisis to shake him into action.

Denial is present long before most turnarounds occur, and it is denial that inhibits corrective action – leading directly to crisis. Employees, suppliers and customers will recognize the truth, often long before management. The hunt for truth can be so painful to the hunter and the hunted that avoidance is unconsciously seen as the best policy. Maybe the problem will go away.

There is no easy answer to the problem of denial. It is a way of thinking, not open to logical analysis. Denial lies within the realm of selective perception in which, under some conditions, managers filter out information and ultimately, hear only what they want to hear or see only what they want to see (Finkelstein and Hambrick, 1996). There is little to be done about this unless the manager is willing to confront his or her biases and face reality.

Salvation by sales

> We have a new sales promotion idea that's a sure winner.
>
> We have this new product that is sure to be in great demand once we get into production in three months.

Expecting salvation by sales volume is a denial mechanism so common that it deserves special mention. Turnaround managers are extremely wary of the promises of new business from excited customers and sales promotion ideas that are said to be sure winners. Are there advance orders? Are they firm?

New products should come under scrutiny even more than existing products. Are there large enough markets? Do new sales estimates take into account typical delays in ramping up, filling the distribution pipelines, and so on? Will the product really make a profit from day one?

Implicit in these questions is the importance of a conservative mind set of constructive skepticism. However, conservatism is no substitute for flexibility in response to crisis. In a turnaround situation it is necessary to have both a conservative and a flexible management team. Certainly innovation surrounding a new product or service offering may be in order, but a reality check would suggest examining current offerings and doing the homework on any new offering.

Objectivity

> Not long ago, two partners in a firm that was hemorrhaging cash were encouraged by one of the authors to buy each other a paperweight with the following advice engraved in large letters:
>
> *FIX THE PROBLEM, NOT THE BLAME.*
>
> Both of them had been wasting a significant amount of time pointing accusatory fingers at one another, each convinced that blame lay with the other. Meanwhile, the fortunes of the company continued to deteriorate as the partners looked for evidence of each other's malfeasance.

It is often the case that ego, the stress and emotions of the moment, or confusion can so cripple managers that their objectivity evaporates. Loss of objectivity results in unfairness, resentment, fear, and confusion throughout the work force and among other company stakeholders. Successful management is not about placing blame. The worst possible environment in which to conduct business is one where someone must find fault and someone else must repent publicly.

The partners in the above case lost their focus and became paralyzed when faced with problems. All they could do was point fingers. Finally, one sold out to the other, left the company but then eventually came back as an employee. After that rather surprising development, the company was successful.

Goals of management and company goals

George Mater's construction company was successful and held in high regard by the entire industry. This led him to deep involvement in the industry association at the national level. He became its president and traveled widely on the association's behalf. All of this took time away from his business, and he lost control. He eventually found himself in a turnaround situation.

"The worst possible environment in which to conduct business is one where someone must find fault and someone else must repent publicly."

> “Compatibility between the company and the goals of top management personnel is critical.”

The business scandals of the late 1990s and early 2000s have brought into stark relief the potential conflict of interest between management and stockholders. However, what is perhaps less obvious, in the absence of public scandal, is the divergence in life goals between managers and owner-managers and others who have invested money or their careers in the company. Frequently, in turnaround situations, managers will claim goals that appear good to the company, but will work toward other goals.

For this reason, even managers of successful firms should ask themselves the following questions:

- How much income and/or stock ownership do I expect over the next five years?
- How much time do I plan to devote to the company over the next five years?
- What other business and personal interests do I have, and how important are they to me?
- What is my role in the company – what functions do I see myself performing now and in the future?
- What do I see as my major strengths (sales? marketing? operations? R&D? finance?)

All too frequently, CEOs want to make all major and sometimes minor corporate decisions; spend time with their families and friends; be involved in community and other activities; make a lot of money; and develop new and often unrelated ideas. If they head up smaller, growing companies, they want to maintain a majority interest in their companies. There are not enough hours in the day and money to be had to accomplish all these things, let alone achieve the goals of the company.

Compatibility between the company and the goals of top management personnel is critical. Since the stated goals of firms are many and varied; the must-have goals are few in number and would include customer satisfaction, employee support, and cash flow sufficient to cover the cost of capital. For this reason, cash flow and profitability are key objectives and therefore must be quantified – cash flow in dollars, and profit in return on investment.

Planning and implementing

> A looming recession made it clear that a large technology company could face drastic cost reduction. Rather than wait for top management’s order to cut costs by some arbitrary percentage, Ray Sullivan, the new CFO, moved proactively. He asked a team led by one of the authors to institute a large-scale study of his department using function-budget documents the author had developed. These documents described the tasks performed by sub-units and estimated an annual cost for each.
>
> He used these when reducing his labor force by 350 employees – approximately 55 percent. The company suffered no noticeable ill effects from the drastic reduction in force.

The exercise of turnaround planning is a healthy one for management of successful companies (Carmeli and Schaubroeck, 2008). This is largely because continued success tends to breed laxity, even in the best organizations. It is a truism that no organization is exempt from experiencing certain degrees of the lifecycle’s highs and lows. Surprisingly, though, many business leaders do not ever expect their organizations to perform below average and do not plan for fallow periods or even periods of distress (Burbank, 2005).

In a crisis, having an inadequate plan or no plan at all, management often will announce a 5 or 10 percent cost reduction across the board to see if that will return the company to

profitability. Often, a second or third round of cuts occurs because the first was inadequate. Eventually, employee morale weakens and concern over job stability demoralizes staff and paralyzes rebound efforts (Burbank, 2005).

Multiple waves of cost reduction due to inadequate planning are destructive to companies for several reasons. First, an equal reduction across the board has little negative effect in departments and divisions that are already overstaffed. But they cut beyond the fat into the muscle of departments that are being managed efficiently. Furthermore, the message that is then sent is clear: pad the budget and the payroll in the future.

Second, successive layoffs keep employees focused on who or what is next, not on company business. The good people in the organization prepare their resumes and leave. The poor performers hunker down and hope no one notices them or their departments. The remaining few will not step forward and be creative in finding solutions to problems for fear of the risk inherent in any creative act.

The lesson here is to limit the negative impact of a business downturn by planning for adversity in advance – create and maintain a less-than-expected case scenario. The exercise includes strategic and tactical elements. The strategic element involves a review of management – do senior managers have the mentality, will, and expertise necessary to accomplish a turnaround? Often they do because their existing relationship with employees, customers and suppliers allows them to change the corporate culture in response to a downturn (Connors and Smith, 1999). Sometimes they do not.

An analysis of marketing, operations, research and development and finance strategies should follow. Management should create a 12-month tactical plan that includes profit and cash flow goals, then develop less-than-expected income and balance sheet forecasts so conservative that there is an 80 percent chance of meeting or exceeding them.

> When either of the authors in their roles as consultants is hard pressed by a client to base plans on a best estimate instead of a less-than-expected basis, we use a coin flip as an example. As the coin spins in the air, we ask the client: ''You don't want to base your whole plan – the future of your company – on a coin flip, do you?''
>
> ''No. Absolutely not,'' comes the reply.
>
> ''Well, if you develop your budget on the best estimate forecast, which you agree is a 50-50 proposition, that's exactly what you're doing.''

Naturally, one can expect the objection that to base marketing and other budgets on less-than-expected results is to invite less-than-expected results. On the other hand, many costs are variable – if best estimate sales occur, the funding will be available to meet best estimate marketing budgets. Should a turnaround situation occur, the company will be prepared to cover the fixed cost gap and show a profit.

Character and communication

> Late one evening a call came from the CFO of a growing furniture manufacturing company. In the face of an escalating cash shortage, the COO of the firm had ordered him to ''manufacture receivables'' in order to qualify for loans from the company bank. This involved fraud: issuing invoices to the bank to draw on the firm's accounts receivable loan before the invoiced merchandise was shipped. The CFO objected, but the COO assured him that this was a one-time occurrence. He was threatened with dismissal if he did not follow through.
>
> It all started very small, but as time passed, rapid growth continued, the need for more, and more cash in advance was required. Eventually the bank became suspicious and investigated, and what was by then a multi-million dollar fraud was uncovered. An otherwise decent person with a wife, two children, and a large mortgage was fired (along with the COO), just as the economy worsened. There was little one could do but commiserate.

In a turnaround situation, management's reputation is already damaged. One objective of turnaround management is to revive stakeholders' faith in the organization. Ethics are not optional. Surprisingly, existing management may still have credibility (Connors and Smith,

> “Management should create a 12-month tactical plan that includes profit and cash flow goals, then develop less-than-expected income and balance sheet forecasts.”

1999). It builds on this credibility, in part, by developing a conservative turnaround plan and then delivering on the promises implied in the plan.

Sometimes exigencies make it impossible to deliver on an agreed upon plan. Even then, stakeholders will often support management if the communication link is strong and they know about problems as they occur. In a turnaround, stakeholders will assure you that no news is even worse than bad news. The company cited above was profitable and its cash flow difficulties were easily solved, even in the face of a worsening economy. Slower growth allowed the cash deficit to be made up. The entire tragedy could have been avoided had the COO and CFO acted with courage and character.

The lesson here is about reputation. The managers who demonstrate ethical behavior and communicate with stakeholders effectively when times are good are most likely to be trusted and followed when times are bad.

Staying out of trouble, like getting out of trouble, requires management to understand that their every pronouncement and act carries with it symbolic meaning to others. Actions that demonstrate openness and ethical behavior by management are symbolic as well as material, whether the company is in crisis or taking steps to avoid it. Following a reduction in underperforming stores and a reformulation of its growth, Howard Schultz is hoping to take Starbucks back into the glory days of its youth. Significant in this process, and on display, is his magnetic character and the inspiration he brings to the table.

Turnaround managers see companies at their worst; but lessons learned from these experiences can keep successful companies performing at their best. Understanding the cost of capital and cash flow, demanding truth in the face of denial, funding adequate information systems, and understanding financial statements are instrumental in recognizing danger when it threatens. Keeping management’s goals aligned with company goals, planning for trouble to avoid trouble, and encouraging objectivity and ethical behavior are practices taken from turnaround situations that can be employed to keep companies healthy.

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