

# Strategic Decisions in a Distressed Organization The Window of Opportunity

BY: Tommy M. Onich CTP

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Distressed organizations and their stakeholders all face a fundamental strategic decision, to attempt a turnaround or dispose of the firm in some form. This necessitates a turnaround or sell analysis which provides the basis for strategic choice.

Most troubled organizations have two important characteristics which determine the opening tactics necessary to achieve this goal; there is limited time in which to act, and they rely upon dysfunctional management information systems.

The time available for management to make decisions is substantively determined by available cash. Poor financial performance has usually impaired financial resources and time becomes a rapidly diminishing resource. If threats from any of numerous constituents become elevated available time will be reduced effectively to zero with the onset of a full blown crisis.

Typically management information systems have been adversely affected by extraordinary demands for all resources. The ability of the organization to deliver useful information is further impaired by the human factor. Denial is often pervasive; the result is a paucity of critical thinking and reluctance by any one to be the harbinger of bad news.

The extraordinary demands upon custodial management and lack of perspective are a powerful and negative force. As a result information systems frequently produce data which is late, erroneous, insufficient or incomplete. In some cases little or even no useful data is produced.

Flawed information systems and time constraints create a harsh, unforgiving, ambiguous and urgent environment. Within this environment success or failure is often determined within the first few months or even weeks of committed recovery planning. If this window of opportunity is not used properly, there will unlikely be a second chance. The result will be the erosion or even destruction of any remaining corporate value.

Unequivocally the first tactics to be employed involve the cash management function, management information systems and managing threats to the organization. Executed concurrently these tactics; husband all resources, collect and correct data, provide a framework for strategic choice and its execution and prevent both external and external threats from becoming manifest.

Failure to embrace these tasks and successfully execute them will preclude any successful turnaround or disposition.

## CASH /MIS

The explicit goals are:

- To control cash disbursement
- To determine flows
- To enhance revenue and decrease costs
- To restore the integrity of the MIS function as needed, including accounting

At any given time in the planning period a significant cash deficiency may result in catastrophe. Immediate control of cash resources is of such importance it is far better to exercise it in excess than insufficiently.

Control is the first goal. It is important that all authority for cash disbursement resides with one person. This person must be experienced in cash management within a distressed organization. Managing limited resources and multiple demands presents a level of threat to the organization that requires skill and experience unlikely possessed by those with only custodial experience. Often companies appoint a Chief Restructuring Officer (CRO) with requisite experience. In addition to managing cash this person contributes to the determination and implementation of strategy.

The Cash Budget is the primary tool necessary for cash management. It is an accurate record of historical revenues and expenses, a well reasoned estimate of the future, and much more.

Properly completed the Budget will yield rich dividends in the decision making process and ultimately in the execution of strategy. It will;

- Assist in the determination of available cash resources
- Quickly outline opportunities for cost reduction and revenue enhancement
- Yield insights into accounting and MIS deficiencies
- Provide accurate historical data and assist with pro forma planning under different scenarios
- Provide a breakdown of revenue and expense in detail by; product/department/division
- Provide insights into the long term viability of the firm
- Enhance the capability for market planning
- Yield information which is valuable in the preparation of other reports such as the Income Statement and Balance Sheet

The preparation of the Budget is an evolutionary process, given data and time constraints. Often cash is problematic immediately and a simple report must be prepared ad hoc with a very short look forward.

This will likely be a form of daily cash report. In a simple format this report includes revenue, disbursements, bank position and float. It looks forward about two weeks and should be nearly 100% accurate. It is the first line of defense against sudden disaster and will quickly delineate priorities.

As data is gathered, tested and refined, monthly and yearly reports can be prepared in a continuum through the period required to execute strategy. This process must be governed by a need for both speed and accuracy.

The establishment of an independent test center will provide autonomous verification that data is reliable. The use of incremental testing which is contingent upon the perceived risk of the center will optimize the use of time. Thus the parameters of both speed and accuracy are both accommodated.

Operationally the centre also assists with the correction of accounting and MIS deficiencies while the budget process is ongoing. This may seem counterintuitive to the reader, again the budget is an evolutionary and recursive process. During this process some information is used, some is evaluated, and some is rejected and corrected. Simultaneously MIS and accounting deficiencies are addressed incrementally. In a distressed environment concurrence of activities is essential; a linear process of execution will fail given time constraints.

The test centre will also provide an independent review of assumptions used in the formulation of pro forma revenue and expense. The autonomy of the test centre is important in this process. While the centre may be staffed with company employees its head should be independent of the organization and a direct report to the CEO

Testing will include proof of revenue and expense tests but will also include some balance sheet items such as hidden collateral, non performing assets and past due liabilities. Testing is incremental in both depth and breadth. Tests begin with a basic or cursory evaluation and can be increased to a forensic level as needed, they include;

- Financial Statement Analysis
- Comparison and Analysis of the Trial Balance
- A review of the General Ledger
- Books of original entry such as purchases and sales
- Source documents

It is important to note that the budget process will yield benefits even before it is complete. These will include early opportunities to improve the company's cash position and to improve deficiencies in management information systems.

Completion of the budget should not prevent management from exploiting these opportunities. Planning and action are not mutually exclusive, indeed their concurrence is essential in a distressed environment. Positive action should not be encumbered

by excessive analysis, in such an environment the only management sin is hesitation.

While the budget is being developed, and cash is being tightly controlled it is important to seek cash from all sources.

Unlocking additional potential sources of capital requires a balance sheet which is current and accurate. It is unlikely that one is available and it must be created.

The completion of this exercise will allow us to determine if additional capital can be raised, capital sources may be derived from;

- The sale of non core or non performing assets
- Amending payment terms on outstanding debt
- Collection of past due accounts
- Statutory or non statutory restructuring
- Additional debt including DIP
- Amending terms on A/P or A/R

The balance sheet must be completed with a critical eye. The data collected will be from source as much as possible, or verified independently. The following steps will result in an accurate view of all assets and liabilities.

1/The visual inspection and inventory of all tangible assets at all locations. This includes: plant, equipment, vehicles, real estate and inventory.

2/An inventory of all intangible assets including A/R, patents, trademarks, leases and interests in other entities.

3/A professional valuation of all assets.

4/Verification from source of current balances for all loans, mortgages and financial liabilities. Particular attention must be paid to those that are less obvious such as third party liabilities and contingent liabilities.

5/Through the use of competent legal counsel, the verification of all encumbrances, liens or mortgages on company assets.

The reader will recall that our explicit goals were; to control the disbursement of cash, to define historical data, seek additional sources of cash and restore MIS. During this process a wealth of information will be revealed relevant to the choice of strategy and its execution.

Of particular note will be key information necessary in the turnaround or sell analysis. An actual turnaround attempt will have three requisites: cash resources, a viable core product/service and competent management. The completion of the CASH/MIS goals will provide most of the data necessary to determine if these criteria are met.

It is necessary in parallel to evaluate both internal and external threats to the organization. This process must be concurrent, if is not a threat will likely become manifest.

## THREATS

The most significant threats to the organization will likely originate from the companies creditors with secured lenders having primacy. It is important that nothing is taken for granted and the secured lenders themselves confirm their latest position. This will include any letters of demand, forbearance, or default. In addition all loan documentation from origination should be inventoried and cross checked with the lenders.

An inventory and review of all outstanding or pending litigation will likely encompass claims of unsecured lenders including third party claims; in addition it will include such threats as environmental or human resource issues. Each case or potential case must be clearly documented with current information from source or counsel. A central file should be created to consolidate the results of this review with key dates and timelines.

It is important to avoid precipitous action from any source. Even a relatively small event such as a nominal judgment can trigger a downward spiral. Regardless of the current position of the company the best way to achieve this is with open, honest and forthright communication with other stakeholders. If company management is acting with reason and prudence all stakeholders are likely to cooperate.

Lastly there are other threats which we may class as internal, these include:

- Employee or union relations
- Compliance issues
- Supplier and client relations
- Operational risks

Employee or union relations are of significant import. Usually employees at the lowest levels are well aware of the condition of the company. In this environment the notion that a turnaround manager can simply wield an axe and cut staff arbitrarily – keeping employees motivated, is false. Cuts in staff complement are almost always necessary however improving operational efficiency requires that morale must actually increase. This requires skilled leadership, transparency and communication.

Compliance issues will vary by geography and business. Most organizations will have issues involving health and safety, labor and employment and the environment. Specialized and experienced counsel should be used to review outstanding regulations. Once determined these can then be applied to current practices with remedial action prioritized as necessary.

Both suppliers and clients are key stakeholders. The loss of an important supplier when cash is limited and credit unlikely will have serious consequences. Often pressure for payment from needy

suppliers will lead to promises by the company which cannot be kept. Above all commitments and promises must be kept.

It is essential to review the firm's customer list in light of potential threats. It is axiomatic that selling price must exceed production costs, however in many troubled companies some products are being produced at low or negative margins, often these clients are most problematic. The budget process will quickly reveal who these clients are. The size of clients purchases must not be confused with their importance.

Lastly, operational risks include issues such as the condition of the plant and equipment and essential payments. Time spent in front line operations will quickly reveal deficiencies in the plant which require correction. A list of essential payments, their approximate amounts and timing will be found in the cash budget. Simple diary notes are often the most effective way to prevent problems.

In conclusion, within the exigent and ambiguous environment of the distressed organization there will be two possible strategies. These are the liquidation of the firm in some manner or to attempt a turnaround. In turn this decision can only be made subsequent to a turnaround or sell analysis. There are clear and unequivocal opening tactics necessary which will allow the organization to make a strategic determination and provide the framework for execution.

These tactics involve managing cash, restoring the MIS function and addressing both internal and external threats to the organization. The information and methodology contained in this article will provide an effective guide for their successful execution.

## ABSTRACT

Distressed organizations must all make a fundamental strategic decision which is to attempt to restore fiscal health or dispose of the firm in some manner. The basis of this strategic choice is provided by the turnaround or sell analysis. In a distressed environment time constraints allow for a very narrow window of opportunity for recovery planning. Flawed information systems and their product usually impede the analytical process. If the correct opening tactics are not used the window will close precluding any successful turnaround or disposition.

This article focuses upon the opening tactics necessary which allow the turnaround or sell analysis to be complete and actually provide a framework for the execution of the strategic choice.

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*Tommy M. Onich CTP is the president of TCMI a full service turnaround firm with offices in Buffalo New York and Toronto Ontario. He may be contacted at [tonich@turnaroundinternational.com](mailto:tonich@turnaroundinternational.com)*