

The CFO's Role in a Corporate Turnaround

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In a turnaround, the role of the chief financial officer (CFO) is more important than at any other time in the corporate life cycle. One is reminded of the words of the French historian Emile Durant: "The men who manage men, manage the men who manage only things, but the men who manage money, manage all." Marketing and operations are less critical than finance in the emergency stage of a troubled situation.

The CFO's importance is based on the harsh realities of difficult financial circumstances. Severe external and internal pressures cause this time to be one of test and challenge. Successful turnaround CFOs know that their role is much broader and more creative than a mere hatchet man or super cost cutter. Instead, the organization requires that financial perspective be injected into every area of decision-making and strategy.

Financial management tasks differ during the emergency, stabilization, and return-to-growth stages of the turnaround.

EMERGENCY STAGE

The main responsibilities of the CFO in the emergency stage are the following:

- Provide the bridge financing that is necessary for company survival,
- Evaluate the company's operating units, and
- Restore financial discipline.

Bridge financing responsibility involves actions to assure that external and internal sources of cash are available to "bridge" the company until operational bleeding can be stopped. Cash is the lifeblood of any business, and you must treat negative cash flow like you would treat a human body that is bleeding. First, you have to control the bleeding by applying a tourniquet; then you analyze the nature of the wound, and perform the necessary surgical procedure to stop the bleeding permanently. In most large companies, this is more than an operational problem. It involves winning support of external lenders in the initial stage before the operational bleeding can be stopped. These massive refinancings involve complex negotiations, often

with many banks on a worldwide basis. Such action requires patience, professionalism, and a bit of levity.

Sometimes a less than solemn style can break the ice in difficult negotiations. Once, when negotiating with lenders, the CFO of a major automobile company pointed a toy pistol at his head and threatened to shoot unless they agreed to his company's proposal. A sense of humor is necessary to tide one over the tedious negotiations that accompany a troubled situation, particularly when billions of dollars of debt are at stake.

Most smart money people in troubled situations realize that the lenders are only the first line of defense. A company must quickly develop internal sources by spinning off operations, managing working capital more efficiently, and gaining tight control over the cash flow pipeline. A major automobile company serves as an interesting example of a company that managed its internal assets quite well. It discovered that by controlling its inventory of cars, and by trying to match production as closely to the market as possible, it could vastly improve cash flow. Cost cutting measures included posting of notices in men's rooms to take only one paper towel. The company sliced its break-even point in half. All of these tactics helped to develop an "internal draw-down" of over a half billion dollars.

The finance function is also principally responsible for evaluating the viability of the company's *operating units*. If at all possible, profitability and market growth will play a part in making decisions regarding business divestitures. In a truly severe emergency, viability is predicated on cash flow as opposed to earnings or market growth. In some severe cases, even profitable units are sold off to protect the perceived "core" business of the company.

A viable core operation is needed to provide a large enough sales umbrella at decent margins to sustain a firm while its troubles are defined and corrected. The core must achieve positive cash flow or be in a position to quickly sustain positive cash flow. It usually has competitive products, plants, and distribution outlets. Reasonable market penetration (but not a dominant share) to sustain the economics of the business is a necessity. The CFO serves a pivotal role in forcing reality to

overcome wishful thinking in troubled situations. An objective appraisal is absolutely essential to avoid the kind of wishful thinking that precedes bankruptcy.

In addition to squeezing money from current operations, the CFO will most certainly be required to engage in divestment and/or liquidation proceedings for those portions of the company that must be sold off. Of course, the CFO must

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play a very important role in getting "top-dollar" for these operations. In most cases the "going-concern" value will exceed the liquidation value. This may not be the case when asset values have been carried substantially below market on the books. It is the responsibility of the CFO and his department to ensure that management is properly apprised of the highest value that can be received from the disposition of business units and/or assets. I have personally seen cases where the financial department took an uncreative view of this responsibility and sold off assets well below those that could be achieved had the business unit or assets been properly "packaged."

Of utmost importance in the emergency stage is for the CFO to *restore financial discipline*. This means instituting tight control of the cash flow pipeline and eliminating "creative" accounting. Control of the cash flow pipeline involves controlling what goes out and stopping anything from coming in, if necessary. Accounts payable should be frozen until you have analyzed where you stand. There is no need to pay someone for things you've already gotten when critical items you desperately need are being put on C.O.D. Controlling what goes in the pipeline means control of purchasing, head count, and capital item commitments. By accomplishing such mundane things as curtailing salesmen's practice of granting extended terms to customers, selectively adjusting payment policies, and cutting back inventories of slow-moving items, substantial reductions in working capital requirements can be achieved.

Eliminating creative accounting practices is necessary to get a true picture of where a company stands. One of my turnaround clients had been overcapitalizing many items that would normally be expensed. I reversed this practice, but took a substantial one-time write-down to do so. *Table 1* shows the most prevalent creative accounting practices encountered in

“CREATIVE” ACCOUNTING CHECKLIST

- Capitalized research and development costs.
- Lease arrangements with “side letters” that still remain off the balance sheet.
- Capitalized items such as training costs, interest costs on loans, computer setup, and software costs.
- Lack of routine maintenance on plant and equipment, causing potential major renovation.
- Treatment of extraordinary income as ordinary and ordinary expenditures as extraordinary items.
- Valuation of inventories at market, rather than at cost.
- Increasing annual results by booking greater-than-legal share of partially owned subsidiary’s income.
- Valuation of assets at inflated values.
- Dividends from subsidiaries improperly stated.
- A “Department 99” to invent customers (Equity Funding), ammonia or vegetable oil (Billy Sol Estes), disc drive inventory, by filling packages with bricks (Miniscribe), false sales of wind turbines to India (Kenetech) or false or misleading re-insurance schemes (AIG) that create false profits.
- Off-the-books partnerships or special purpose vehicles that hide debt from shareholders (Enron).
- Recognizing income immediately from long-term contracts before delivery of service or product (Enron).

my experience. Not all creative accounting practices increase a company’s earnings artificially, and I have come across several that were understating legitimate earnings. The “Department 99” problem (creation of nonexistent assets) still exists. In the ’60s we had the Billy Sol Estes agricultural scams; in the ’70s we had the Equity Funding case. In the ’80s we had the Savin Corporation scandal; in the ’90s we had the Miniscribe scandal, and more recently, we had the Enron escapade. During the first few weeks of the turnaround, a CFO must make strenuous effort to eliminate all such activities.

STABILIZATION STAGE

A CFO’s responsibility changes in terms of degree and urgency after the emergency stage is completed. Rather than cash objectives at the expense of profits, profitability takes on a stronger role; rather than debt liquidation, the emphasis is on balance sheet enhancement; rather than cost reduction, the emphasis is on profit improvement. In addition, the company in this stage has the time and resources to develop better control and managerial accounting systems. The main financial activities are as follows:

- Liquidity improvement,
- Balance sheet restructuring,
- Control systems development, and
- Managerial accounting development.

Liquidity improvement in the stabilization stage is achieved more by the institution of solid management practices than by the wholesale ringing of cash flow from unproductive

assets. Cash is still intensely managed, but management is far less likely to sell a high-performance subsidiary for cash flow purposes as it might have been forced to do in the emergency stage. One key strategic move that the CFO can influence is to slow the growth rate of a company’s core business in order to moderate the demand for new capital. Typical of companies in this stage is one that decided to aim for drastically improved margins by sharply restricting its sales growth. It aggressively weeded out unprofitable businesses and products, selectively increased prices on high value lines, thereby improving margins, avoided costs associated with acquisitions, and improved earnings and cash flow dramatically.

Balance sheet restructuring centers on obtaining additional lender debt service concessions and restoring the balance between short- and long-term borrowing. Many troubled companies develop a severe short-term debt problem by funding long-term assets with short-term debt. Correcting this imbalance is not usually possible during the emergency stage. A turnaround company must be careful to shrink its debt service load more than it shrinks its business. Lenders must be convinced that a combination of debt conversion to equity, lower rate terms, longer maturities and packaging of loans for sale to specialized firms are as much in their interest as in the company’s.

Control systems development must go beyond the cash-flow pipeline controls of the emergency state and concentrate on operational control systems. Most financial officers have a natural tendency to rely on the traditional quantitative

measurements as well. In a turnaround situation, tough, no-holds-barred operating meetings are necessary for hands-on management.

Good *managerial accounting* does not exist in many corporations. Managerial accounting must be aimed at the internal needs of the company's managers and not be dominated by external financial reporting requirements. The managerial accounting system must profile the company's business performance by product lines, plants, customer segments, and distribution channels. At a summary level, it should be linked to the financial accounting system, but only if it can avoid being contaminated by it.

THE RETURN TO GROWTH

After the healing of the stabilization stage, a company enters the return-to-growth stage of its turnaround. Financial management in the return-to-growth stage is not as critically important as it was in the emergency and stabilization stages. In direction and intensity, financial management in this stage of the turnaround more nearly resembles that of a normal company. The main financial management activities are as follows:

- Development of sound and creative financing plans to support a modest acquisition program,

- Maintenance of tight financial discipline throughout the company,
- Use of special techniques to forecast, isolate, and track development expenditures, and
- Financial evaluation of strategic growth decisions using simple financial models.

Creative financing plans are necessary to support a company involved in a turnaround, because cash resources will probably be short. I normally recommend an internal development program rather than an external growth program at the beginning of this stage. However, opportunity availability often takes precedence over timing in many turnaround situations. The chief executive officer and CFO are left scrambling for leverage points in a cash-poor company with products that may not have regained market acceptance. Creative financing through workout arrangements can usually enable you to stretch beyond your apparent financial strength.

The tight financial discipline that was established in the prior stage of a turnaround is maintained, but is usually decentralized in this stage. Successful turnaround companies focus on using capital efficiently, and they fight margin deterioration in the face of growth pressures. What sets the outstanding performance apart is the discipline they exercise in this regard. This discipline includes constant attention to

TABLE 2

FINANCIAL TACTICS BY TURNAROUND STAGE			
Financial Decision	Emergency Stage	Stabilization Stage	Return-to-Growth Stage
Business Integration	Manage for Immediate Cash	Manage for Earnings	Invest in Future Growth
Cash Flow	Close corporate cash flow pipeline. Daily control to get positive flow.	Squeeze cash out of loose systems to become more liquid.	Redirect surplus to growth areas.
Profitability	Not as important as cash flow. Achieved by divestment and drastic cost cutting.	Short-term ability becomes more important. Achieved by running retained operations better.	Some tradeoff of short-term against long-term growth.
Balance Sheet	Minimize debt service requirements and get "bridge financing."	Restructure debt, get into long-term/short-term balance.	Begin external financing.
Working Capital	Squeeze cash and receivables, cut inventories, collect payables.	Squeeze cash out of loose systems. Minimize float, etc.	Maintain tight discipline.
Capital Investment	Curtail except in core business.	Modest, constrained by internal sources.	Increase in strategic growth areas.
Accounting Control Systems	Eliminate "creative" accounting. Cut "systems" work.	Work on tight control systems, managerial accounting.	Decentralize, develop financial models.
Dividends	Eliminate dividend.	Consider reinstating small dividend.	Reinstate dividend.

prices and costs. It also includes rededication to the balance sheet and return on capital criteria abandoned earlier in the turnaround for cash flow consideration.

Special techniques to forecast, isolate, and track development expenditures are needed. Most companies fail to recognize the total scope and cost of their development programs, which may be spread over 100 departments or more. A company in the rebuilding stage should be able to isolate development expenses, including the balance sheet and working capital effects of such growth. Simple models for financial planning centered on five to ten key variables are an especially useful tool for strategic financial decisions at this stage of the turnaround.

A sample of financial tactics by turnaround stage is shown in *Table 2*. This is not an exhaustive list, and it is shown to contrast the various tactics and how they change from stage to stage in a turnaround. Of utmost importance is the integration of these financial tactics into the business strategies of the company as a whole. This means that in the emergency stage, the emphasis and direction are on immediate cash management. In the stabilization stage, profitability transcends cash flow again. In the return-to-growth stage, investments are made for future growth, but as mentioned previously, they must be carefully monitored and quantified to present a clear picture to management.

CONCLUSION

The CFO has a most important role to play in turning around a troubled corporation. During the emergency stage, the CFO plays a major role in restructuring the company's debt, controlling the company's cash flow pipeline, eliminating creative accounting practices and restoring financial discipline to the organization. In this regard, the CFO is much like the assisting surgeon in an emergency room. Later, in the stabilization stage, he must take the lead in rebuilding sound financial systems to monitor the organization's (patient's) progress toward a healthy recovery. Creative talents are put to the test again during the return-to-growth stage of the turnaround when the development of creative financing plans are necessary to support a modest growth program and to reposition the business strategically. There is probably no other time in a company's history when the role of the financial executive is more critical, more demanding, and more professionally rewarding than in a turnaround situation. □

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