Financial Management

PUTTING THE SPUR TO LAGGING RECEIVABLES

Upgrading the accounts receivable staff is in order for many firms. But avoid hiring people who do not enjoy the unpleasant work of collecting bills. They are not effective. They rarely take the trouble to probe a client's defenses. And their lack of interest simply alienates customers.

Management goal: Low turnover in the department. The longer bill collectors work at the job, the better they become. Pressuring the right people requires knowing who a customer is. Pressure and persuasion work best when the collector has a personal relationship with a client. Offer the accounts receivable staff incentive payments for keeping accounts within set guidelines.

Effective management of accounts receivable mean differentiating between customers. Knowing that a company's accounts receivable are slipping on average is not much help. General information does not lead collectors to culprits.

Instead, develop strict guidelines defining slow pay. Divide slow payers into four categories—those who:

- Do not have the ability to pay.
- Pay slowly because of slow internal bureaucracies.
- Traditionally pay slowly.
- Recently began to pay slowly.

In dealing with clients that have:

- *No ability to pay:* Aim for a settlement of bills outstanding before other suppliers realize the situation or before the client declares bankruptcy.
- *Slow bureaucracies:* Speed up the issuance of bills.
- *Traditionally slow payments:* Aim to prevent further slippage.
- *Payment schedules that suddenly slow up:* Ask for a reason for the delay and a promise that it will be made up.

The better a company's records on customers' payments, the more alert the company will be to problems. A quick reaction is the best negotiating weapon. In collecting, knowledge is power.

Source: Frank Uhlman, vice president and general manager, commercial collection division, Dun & Bradstreet.

WORDS THAT PRODUCE FASTER PAYMENT

Calculate the true discount for prompt payment as an annualized rate of interest. This may be all that's needed to remind a customer of the substantial advantage of paying within 10 days.

Instead of marking the invoice with the standardized code (such as 2%/10 days, 30 net), translate the savings into plain English. *Sample:* This is our offer of 36% interest. That's the true annual interest rate in the 2%/10 days, 30 net discount this invoice offers you, if you pay 10 days from now.

Other quick payment offers translated into annualized interest rates:

- 2%/10 days, net 90 days, equals 12% annual interest.
- 3%/10 days, net 60 days, is 22% annual interest.
- 1%/10 days, net 30 days, is 18% annual interest.

If the bill isn't paid promptly, send a photocopy a week later marked: Your discount period ends tomorrow.

Source: Sell More and Spend Less by T. Martin and B. Trabue, Holt Rinehart & Winston.

EFFECTIVE COLLECTION METHODS

- Make calls early in the week. Customers who promise on Friday to pay on Monday often "forget" over the weekend.
- Speak to the person who signs the check. Don't waste time on other employees.
- Be persistent. If customers are out, leave name and number and request a return call. Ask when they are expected, then call back again, and again. When writing a letter for payment, tell customers these messages have gone unanswered.
- Make the call as personal as possible. Always address the customer by name.
- Give the customer a chance to explain. There may be a valid excuse for being late.
- Encourage the debtors to commit for a partial payment. Then use that amount to arrange a payment schedule.
- Don't hang up without specifying details of the payment arrangement. Determine what the next step will be—whether it's to pick up the check on a particular day, call back, etc.
- When customers agree to pay, immediately send a letter formalizing that agreement.
- If a letter threatening use of a collection agency or legal action is sent, don't follow up immediately. Silence makes customers edgy. They will call.
- After setting a deadline for payment, stick to it.
- The embarrassing-pause trick: Identify your company and say that the purpose of the call is to ask about the overdue account. Pause, and say nothing further, no matter how long it takes. Usually it won't take long for the embarrassed debtor to start apologizing and promising to pay. The caller should then insist on a date (it should be one in the immediate future) by which the check will be mailed.

WHEN SHOULD YOU GO TO A COLLECTION AGENCY?

Focus on collecting past-due accounts within the first 90 days. After that time, in-house collection efforts are almost totally ineffective. It's usually more productive then to turn over unpaid accounts to a collection agency.

Source: Richard D. Schultz, president, National Revenue Corp.

HOW TO FIND THE BEST COLLECTION AGENCY

As receivables lag, the pressure to turn past-due accounts over to a collection agency grows. Make sure the agency is equipped to handle the job. Key questions to ask:

• *Do you specialize in accounts of a certain size?* There is a clear difference in the ways that accounts of different sizes are handled.

• *What is your collection record?* A 75% success ratio is excellent; 50%–75% is average. Ask for an audited report of the collection record. Keep expectations realistic. Do not expect miracles with the company's worst deadbeat accounts.

• *May I observe your operation?* Spend several hours watching and listening to agents work on the phone. Judge their persuasive abilities. Abrasive or threatening techniques can reflect badly on the firm or open it to harassment charges.

Fees: Expect to pay 20%–40% of the amounts collected. The agency should provide monthly reports on its progress. Additional charges are likely for more frequent or detailed reports, personal visits by agents, skip-tracing (following a debtor who leaves town).

References: Ask for five. Almost any firm can come up with three satisfied customers, the number usually asked for.

To protect your company, put a cancellation clause in the contract. And the agency should have hold-harmless insurance, which protects the company from harassment suits that can arise.

If the company has numerous small debts that are difficult to collect, it may be desirable to buy a collection agency series of dunning letters. *Cost:* $2–$5 per letter in a four- to six-letter series. *Caution:* The agency will not follow up.

Shrewd tactic: Create the company's own dunning letters, using a dummy company letterhead that seems like a collection agency's. Use legal-sounding language, with words such as *heretofore, notwithstanding,* etc. *Red flag:* It is illegal to display the dummy agency name anywhere on the envelope.

Source: Horace Klafter, lecturer on collection techniques for the Business and Professional Research Institute, Westport, CT.

HOW TO INCREASE CASH AVAILABILITY

For most companies, accelerating receipts to make cash available quickly may be far more important financially than earning the maximum interest on a disbursement float.

The challenge is to get all checks and payments processed and consolidated as soon as possible in the company's main bank account.

First order of business is to sensitize employees to know the difference between big or important checks requiring special treatment and routine receipts. All checks represent cash and should be taken care of promptly.

Rather than holding checks received after 3 p.m. until the next morning, for example, it may be worth keeping employees overtime or hiring extra help to get checks deposited that day. Also, if mail arrives as early as 7 a.m., and the office staff doesn't normally arrive until 9 a.m., it might be smart to add an early shift. Getting checks to the bank by 8:30 a.m., instead of in the afternoon, may save a day.

Recommended: Become familiar with the bank's clearing procedures. Work around those schedules. (It is valuable informatio to know that the bank has a 9 p.m. clearing or a late Friday pic up.) Never let receipts lie around when they could be deposite and earning interest or defraying expenses. Most bankers will a commodate a company's needs.

For distant customers bypass the postal system altogether, an ask the customer to deposit funds directly into a local bank, pre erably one that has a relationship with the company's mai hometown bank. Then the funds can be wired directly bank-t bank with maximum speed.

Plan ahead for special or very large receipts expected from, sa the sale of a piece of property. Alert mailroom employees an leave instructions that the manager should be notified imm diately on receipt of this or any unusually large check.

Even if solid check-handling procedures are supposed to be i effect, make sure they are still working.

Source: John Carroll, partner, Peat, Marwick, Mitchell & Co.

WAYS TO IMPROVE CASH FLOW

• Move payday from Friday to the following Wednesday boost cash flow with what amounts to a free loan from employe over the weekend until the checks clear. Invest the funds durir the interval. Start the system the week bonuses are distributed employees can tolerate the extra days' wait for their pay.

• Copy incoming checks, deposit the originals immediate and use the copies for check posting and accounting.

• Before sending the first bill to a new customer, ask the nan of the person who authorizes payment. Address the bill to th person.

• Prevent bookkeeping from following the comfortable routir of paying all suppliers on one day.

• Give preparation of invoices the highest priority. Prioriti are set exactly backward in many firms. Sending out sales co missions, for instance, often takes precedence over billing.

• Take advantage of the fact that some companies still p promptly on the 10th or 15th of the month after they get a bill. these steady customers are continuously being billed for shi ments, have their bills prepared on the 30th or 31st of the pre ous month (rather than on some other cycle that may have the b prepared on the 25th or so). *Result:* All their orders for the mon are reflected in the bill. *Cash-flow bonus:* The company will paid 30 days earlier for all the orders shipped in the last days the month.

• Send invoices separately from statements. Invoices attach to statements stand a greater chance of being misplaced or s aside.

• Send stamped, self-addressed envelopes with custome bills.

• Be sure cash is invested quickly in a money-market fu rather than left sitting in a checking account.

• Reduce the number of finished products on hand.

• Centralize the spare-parts inventory.

• Scrap, rework or sell obsolete spare parts.

• Standardize auxiliary materials and spare parts..

• Pare down the number of raw-material specifications in us

• Decrease all stocks held for "safety" purposes.

• Reduce the lot sizes used for purchasing supplies.

• Refine the accuracy of the company's sales forecasts.

• Improve inventory controls. *Example:* Early warning sign for stockouts.

• Reduce the delays between individual stages of productio

• Include due dates on all invoices the company sends out.
• Reduce the company's grace period for late payment, and increase the frequency of reminders to late payers.
• Provide customers with information allowing them to make payments directly into company bank accounts.

USE BARTER TO STRENGTHEN CASH FLOW

About 20% of most company business can be transacted through barter. In fact, more than 60% of the companies on the New York Stock Exchange now use barter for a significant number of transactions. *Advantages:* Barter helps companies move inventory, improve cash flow and open up new markets. Barter can be done:

• Through professional barter companies,* of which there are more than 40. *How they work:* A company tells the barter firm what it has to exchange and what it wants in return. *Example:* A CB radio maker wants sales meeting facilities in Miami. The barter firm then contacts hotels to see what they want in exchange. It may offer the hotels linen goods that another company wants to barter. Principal barter firms do not normally charge a fee. They make money by selling some of the inventory they collect.
• Through smaller, local barter exchanges,* which put companies that want to barter in touch with each other. The exchange takes an 8%–10% commission on transactions. They also charge a one-time enrollment fee and annual dues, each of which is usually $300–$500.
• Commercial barter is entirely legal and should not be confused with noncash transactions that take place in the underground economy.
• Barter is a supplement to cash transactions, not a replacement.

*Professional barter firms can be located through a list published by the International Assn. of Trade Exchanges, 5001 Seminary Rd., Alexandria, VA 22311. Barter exchanges are listed in the local Yellow Pages.

Source: Moreton Binn, chairman, Atwood-Richards, Inc., New York City, which handles barter transactions of $500,000 and over.

USING THE RIGHT WORDS

Final demands for payment from delinquent accounts seldom work. But they're useful to tell debtors that further delay is not acceptable and may lead to legal action. Use formal or even archaic language ("whereas," "inasmuch"). Don't sound conciliatory, but avoid phrases like "no alternative" or "you leave us no choice," which imply absolute finality. Demand "settlement in full" rather than "payment in full" to indicate you're willing to be reasonable and work out a plan instead of accepting only a single check for the full amount. But insist on a response within 10 days.

Source: Hal R. Abelson, Abelson Management Services, Columbus, OH, writing in *Business Credit*, 520 Eighth Ave., New York 10018.

AN EFFECTIVE SYSTEM FOR SIMPLIFYING PAYABLES

Check the day's incoming invoices for validity and discounts. Then:

• Determine the best date to make payment on each and wri the check.
• Put each check in a separate stamped envelope.
• Code the envelope (rear lower corner) with the required ma ing date (allow three days in transit for local, seven days for cros country).
• File envelopes in chronological order.
• Each day, mail those earmarked for that date.
• *Result:* Cost effectiveness equal to any computer-base system.

SPOTTING A BAD CREDIT RISK

Now more than ever before a company must be sure of the nancial health of its suppliers and credit customers. *How:* A range a meeting between the company's accountant and th other company's accountant and banker.

Ask the banker: Has the company borrowed against its a counts receivable? Be cautious if it has. *Reason:* Interest rates c these loans are so high at present that the companies borrowir in this manner are short of cash. Be especially wary if:

• Either customer or supplier sales have gone down. Since th company borrows against receivables, its credit line has probab gone down too. Cash may be very tight.
• The company's credit line has increased, but sales have no *Significance:* This may indicate that the company has bee unable to pay the interest on its debt. The lender has added the in terest to the principal, a very bad sign.

Also ask the banker:

• How long has the company been with the bank? If not lon ask: Why did it switch from its old bank?
• Is the company a secured or nonsecured borrower? *Impo tance:* The bank considers the company trustworthy if it has e tended an unsecured line of credit.
• How often do customer or supplier overdrafts occur?
• Is the bank's relationship with the company satisfactory?

Take the time to gather firsthand information about a ne customer:

• Visit the company's place of business. Does it look like reputable and above-board operation? Does the company pro duce a quality product?
• Use a Uniform Commercial Code (UCC) search to uncove creditor or tax liens filed against the company. *How:* File for suc a search at the office of the local secretary of state. *Cost:* Betwee $2 and $10 in most states.
• Obtain credit reports on the customer's or supplier's top o ficers. *Key question:* Have the officers recently transferred pe sonal property to other members of their families?
• Examine the company's financial statements. If they hav not been audited or reviewed by an independent certified publi accountant, be cautious.
• Obtain credit information about each company separately, i the customer or supplier does business through more than on corporation.

Danger signal: The company's lawyer is one who is known fo bankruptcy work.

Ask the accountants:

• Does the company pay its payroll taxes on time? *Significance* Late payments often indicate that the company uses the ta money to meet operating expenses.

• Are payments to a company pension or profit-sharing plan up to date? *Importance:* These are corporate tax shelters that are more likely to be used by a healthy business.

When these queries raise doubts about a potential customer's or supplier's financial status, and that company's business is sound, it will offer a debt guarantee. If not, the company probably doesn't deserve further credit.

Other ways to guard against credit risks:

• Ask for a lien on the customer's inventory.

• Ask for the company owner's personal guarantee.

When a company that owes your company money seems like a candidate for bankruptcy, immediately demand payment on the debt. Threaten a lawsuit. *Point:* The customer or supplier will not want its other creditors to find out about its shaky financial situation. It may pay just to avoid the suit.

Rule for this situation: The first to sue is the first in line to be paid. The rest may get nothing. *Reason:* After the first creditor is paid, there may be no money left for any other creditors.

Source: Edward Mendlowitz, partner, Mendlowitz Weitsen, CPAs, 2 Pennsylvania Plaza, New York 10001.

WARNING SIGNS TO LOOK FOR OFF THE BALANCE SHEET

Many companies will not release an income statement to permit a credit check, but do make a recent balance sheet available. *Problem:* This often does not disclose key areas. Be sure to ask about:

• Debts the company may owe that could have an adverse effect on it. *Examples:* When sinking fund payments must be made. How much remains on a line of credit. What interest rate the company is paying.

• Lease obligations.

• Reserves for anticipated major losses from setbacks such as a product failure, bad debt or fire. Assess whether the reserve seems adequate.

Source: Business Perspectives, available from banks.

TAKING GAMESMANSHIP OUT OF BUDGETING

Most executives will recognize the two classic top-management budgeting traps: the add-10%-to-last-year's-expenses-and-press-for-a-20%-increase-in-sales trap; and the slash-10%-off-all-requests-and-forecasts-submitted trap.

These almost automatic responses to the budgeting process inevitably destroy the real function of budgets, which is to pinpoint opportunities (and threats) for the company and direct the use of its resources most effectively. Worse, subordinates recognize the automatic response and skew their numbers accordingly.

Begin the next budgeting process now, nonquantitatively. The first challenge for top management is to set guidelines for what the company must do to survive in the year ahead, grow in the short term and flourish in the long term.

In practice: A specialty chemicals firm that traditionally pegs research-and-development expenditures to the industry average decides it needs to add a high-margin item to its product line to bolster gross margins. *Options:* Scuttle R&D spending for the year, and retain a patent attorney to license a product from the outside. Or dramatically boost R&D to develop the product inside. Fi decide on the strategy. Then start budgeting.

The next step is to project sales for the year. Subtract the fix costs (such as rent and taxes) and the desired profit margin. Th separate the balance remaining into two sets of expenses:

• Those required to keep the firm operating. *Example:* Sal people's salaries and commissions.

• Those earmarked to help the company grow. *Examp* Advertising.

Think about the sum earmarked for growth as investme money. The goal in budgeting is to get maximum return on tl investment.

The big goal of such budgeting: It allows the company to foc its discretionary expense money, rather than spread it thir across all departments.

Having determined basic objectives and targets for discretic ary spending, set guidelines for departmental budgets. With those guidelines, negotiate final numbers. Middle managers w work harder to make negotiated budgets work than those i posed from above.

Avoid slashing departmental requests across the board. Sel tive additions to requests, along with acceptance of some reque untouched encourage departmental chiefs to submit hon numbers.

Monthly financial checkpoints should be salted with nonfina cial checkpoints. *Example:* If the specialty chemicals firm plan June introduction for its new product, check to see that advert ing is ready by April.

In the weeks following the annual budget go-round, review tl company's reporting system to make sure managers get the rig information to make the budget work.

Ask key managers two questions:

• What information do they need?

• How often do they need it?

Sample result: The company may find that its plant manage need daily information on plant output and direct labor hour Central-office operations managers may need this informatic only monthly. But central-office operations managers may nee company profit and loss statements weekly, while plant mana ers may need them only quarterly, or not at all.

Point: By pinpointing needs at each managerial level, the con pany can reduce the information overload that causes manage to stop focusing on their budgets.

Source: Albert A. Fried, president, Applied Strategies, Inc., New York City.

HOW TO MANAGE THE SHRINKING FLOAT

Electronic processing is cutting the time it takes checks to clea To keep pace with the change, companies must scrap or modi some long-standing cash-management tactics.

New strategies for receivables:

• Use computers to streamline cash management within th company. Many can be linked with the bank's electronic repor ing system to give the company an even quicker and firmer gras of its cash position.

• Offer discounts for payments made by electronic transfer.

• Upgrade lockboxes with a computerized reporting syster through which banks notify customers instantly when a check a rives and when it clears. Bank fees for these electronic reportin

systems vary widely and depend on what balance the company maintains.

Tactics for payables:

• Begin processing bills no sooner than the afternoon of day received.

• Pay with checks drawn on small banks that do not have electronic data processing or other services that speed check processing.

• Mail checks from clogged postal areas. *Example:* Checks mailed from midtown Manhattan usually arrive a day later than those mailed from the Wall Street area.

• If the company writes its checks against an out-of-town controlled disbursement point, it should set up at least one other point and monitor the performance of each. *Reason:* Since clearing time is changing in many areas, only trial and error can determine the most efficient disbursement point. And if the company switches disbursement points, it should also monitor the new ones periodically.

Important: Several years ago, the Federal Reserve Board started clamping down on companies that took flagrant advantage of remote (as opposed to controlled) disbursement points. The Fed's current guidelines discourage companies from using remote disbursement points to make payments to individuals. Companies must also have a reason for banking at the location. *Examples:* An office, plant or branch nearby. *Or:* A prior relationship with the bank.

Source: George Manning, assistant vice president, Chemical Bank, and David Spiselman, consultant specializing in cash management, Jamaica Estates, NY.

EARLY SIGNS OF DISTRESS

How companies usually skid into financial collapse:

• Operational problems sap liquidity.

Example: W.T. Grant decides to expand operations. To fill its new square footage, it changes its merchandising strategy and begins selling big-ticket items. To do this, it begins offering credit. Receivables mount uncontrollably, reaching $650 million at the time the company enters Chapter 11 bankruptcy.

• Companies try to borrow to cover their loss in liquidity. This does not solve root operational problems.

Example: Borrowing to improve cash flow did nothing to solve Food Fair's problem of poor inventory management, prior to its filing for bankruptcy.

• Financial difficulties precipitate a change in management. But that new management's turnaround plans are hurriedly prepared and often fail for lack of time. With high interest rates and economic volatility, the time it takes for a company to collapse in this way is significantly compressed. *Result:* Companies must develop leading indicators to complement traditional financial reporting systems.

Banks themselves are developing leading indicators for analyzing companies as credit risks. *Example:* In addition to relying on the underlying strength of a company's assets when assessing its credit rating, banks are focusing more on current operating trends such as gross margins, backlogs and productivity indexes.

The objective in developing leading indicators is to establish controls that alert top managers to operational problems before the difficulties are reflected in traditional financial reporting systems.

To develop indicators:

• Review the financial variables that have given the company the best advance warning of trouble in the past. They vary by industry. *For capital goods companies:* Order backlogs. *Food companies:* Number of customer accounts. *Retailers:* Sales per square foot. *General manufacturing and service companies:* Unit sales and profit margins.

• Determine the company's definition of success; quantify the definition. Watch the month-to-month trends.

• Quantify and track employee morale and productivity. *Example:* Number of absentees per month.

• Use the company's traditional financial reporting system more effectively. Chart key financial variables on a single graph. As soon as the variables combine to show a negative trend, get an operational explanation. Determine whether the problems are peculiar to the company, the industry or the economy as a whole.

When analyzing both leading indicators and traditional variables, think of the company as a potential acquisition. This focuses on the future rather than the past.

Source: Frank. J. Zolfo, partner and turnaround specialist, Touche Ross & Co.

QUICK FORMULA FOR ANALYZING FINANCIAL HEALTH

No single financial measure—return on equity, debt-equity ratio, etc.—alerts top management to an emerging financial problem. Closest to such a signal is the Z-Score, developed by Dr. Edward Altman, finance professor at New York University. The Z-Score is useful for manufacturing companies to identifiy a deteriorating or an improving financial condition when plotted over time.

The formula:

$$Z = 1.2x_1 + 1.4x_2 + 3.3x_3 + 0.6x_4 + 1.0x_5$$

$$x_1 = \frac{\text{current assets} - \text{current liabilities}}{\text{total assets}}$$

$$x_2 = \frac{\text{retained earnings (from balance sheet)}}{\text{total assets}}$$

$$x_3 = \frac{\text{earnings before interest and taxes}}{\text{total assets}}$$

$$x_4 = \frac{\text{market value of equity}}{\text{total liabilities}}$$

$$x_5 = \frac{\text{net sales}}{\text{total assets}}$$

To read the results:

• The company is financially healthy when Z is 3.0 or more.

• The company is financially ailing when Z equals 1.8 or less.

• The situation is neutral if Z falls between 1.8 and 3.0.

Use the Z-Score internally to:

• Track the company's financial conditions over time.

• Compare a company's performance with that of competitors.

• Set financial goals.

Use it externally to:

• Perform credit analyses.

• Help determine an accounts receivable policy.

Source: Robert Roussey, partner, Arthur Andersen & Co., Chicago.

HOW TO DEAL WITH A COMPANY IN CHAPTER 11

Many companies are coming up against customers or suppliers

in severe enough financial difficulty to file for Chapter 11 rehabilitation. (It is far more common than actual bankruptcy that results in liquidation.)

What suppliers should do: Use extreme caution in reopening lines of credit with a Chapter 11 company. It is easy to identify such a firm, as it must have DIP (Debtor in Possession) after its name. *Reason:* Although new debts have priority over old debts coming under a Chapter 11 proceeding, there is no guarantee that the company will have enough money even to pay current creditors. Operating problems are not corrected just because the company has filed under Chapter 11.

General rule: Extend no credit at all unless there is reason to believe that the company will survive and confirm a plan. Then, whatever credit line the supplier extended before the Chapter 11 filing should be greatly reduced until the company proves that its cash flow is adequate. *Example:* A pre-Chapter 11 credit line of $100,000 might be reduced to $10,000.

Stay out of the picture during the first 30–60 days after a filing under Chapter 11. *Reason:* It takes that long to learn whether cash flow is sufficient and whether the creditors will stick by the company.

Secured creditors may have a lien on all liquid assets of the company. If this is so, their claims have priority. Such a creditor may choose to cease financing the company's assets. *Red flag:* Whenever the assets of the company are pledged, risk exists for all future unsecured creditors.

Payroll, attorneys' and accountants' fees, taxes and certain claims take priority over repayment of trade debt. Sometimes one current creditor gets a super-priority. *Example:* A key supplier refuses to grant credit unless it gets special consideration, and without the supplier the company cannot do business. The court and creditors committee may agree to give that supplier priority over other new creditors.

Even if a company confirms a plan and is discharged from a Chapter 11 (at which point it can erase the DIP from its corporate name), the danger period is not past. The credit risk is still high immediately after the company comes out of Chapter 11. *Common situation:* A company scrapes together every last penny by refinancing its assets with the creditor's blessing. Then it faces going out of business within 90 days after confirmation because of insufficient cash flow. Many of those companies that do survive remain weak for years.

Do not take the company's own cash-flow projections at face value. Instead, assess its debt-payment schedule and its cash requirements, and then determine if cash flow warrants the granting of new credit.

Sources of financial information about the company:

- Members of the Chapter 11 creditors committee.
- The creditor committee's accountant (who supplies reports to the committee).
- To a lesser extent, the company's bankers. *Note:* if they will not talk, assume that the company's problems are serious.
- The company itself.

Customers of a Chapter 11 company face less danger in dealing with it than do suppliers who are waiting to be paid. If the relationship has been a long and fruitful one, stick by the ailing company. But play it smart. Hedge with alternate suppliers in case the company does fold.

Source: Malcolm P. Moses, Malcolm P. Moses Assoc., financial consultants, Merrick, NY.

HOW TO LIVE THROUGH CHAPTER 11

Most companies underestimate the tremendous opportunities for improvement beyond mere debt restructuring that Chapter 11 offers.

Essential: Find a compatible Chapter 11 attorney, accountant and, perhaps, a consultant. Meet all their associates who will be working on the case throughout the proceedings.

- Contact the bank. Inform it of the likelihood of Chapter 11. If it is a secured lender, win its support.
- Manage cash flow so there is enough cash on hand to get through the difficult first weeks after filing.
- Use the opportunity to cut all deadwood operations from the company.
- Terminate all burdensome leases and contracts. (This is legal under the statute.) Canceling onerous agreements can be a boon to future operations.
- Liquidate excess or stale inventory. Chapter 11 provides a chance to take the write-offs the company has been avoiding for years because it did not want to hurt its credit standing.

How to get new credit: Explain the circumstances of the filing to all suppliers and other credit sources. Supply them with current financial information and detailed projections. If the cause of the problem has been alleviated, assure them that they will be paid—but only if that assurance can be met. *Point:* Many recent Chapter 11 filings have been caused by high interest rates and excessive debt. Once loans are renegotiated, the affected companies often can function normally again.

How to handle customers: Keep them informed. In most cases, they will try to continue an established relationship.

HOW MUCH SHOULD A COMPANY BORROW?

Total borrowings should not exceed the sum of:

- 10% of the net working capital
- Plus 5% of cash and receivables
- Plus 10% of one year's net income.

From this total, deduct 3% of the long-term debt.

Bankers use this formula to make sure they don't lend too much money.

Source: William G. Torrace, management consultant, Troy, MI.

FACTORING VS. ASSET FINANCING

Using receivables to replenish working capital is expensive and often the last resort, short of bankruptcy, for ailing businesses.

Two variations of this type of financing can provide useful options for growth companies lacking access to unsecured funds, however.

Factoring. An outright sale of accounts receivable. The factor makes cash available as an advance (at 2%–3% above the prime interest rate) against purchase installments collected as accounts mature. *Drawbacks:* Customers must be notified of the change and pay the factor directly. To customers it can look like a sign of trouble.

Asset financing (also known as commercial financing). It is secured borrowing, possibly from a bank, but usually from a more specialized high-risk lender. The lender uses accounts receivable or other assets as collateral. Customer notification is not required.

In both cases, sources of receivables financing are not so concerned with an applicant's financial statements. Prime concerns are the quality of accounts and the borrower's previous and projected ability to generate enough cash to pay off the debt.

Advantages of factoring:

• *Simplification and safety.* The factor assumes responsiblity for collection. That, in effect, guarantees customer's credit.

• *Reduction of overhead.* With back-office problems minimized, executives are free to focus their attention on areas for which they are best suited. *Examples:* Purchasing, production and sales.

• *Continuous flow of funds.* Once a factoring deal is made, new receivables are batched and sold to the factor periodically.

Benefits of asset financing:

• *Non-notification.* A big plus. *Reason:* Account ownership does not change hands, so borrower's customers pay their bills directly to the supplier, rather than a factor.

• *Cost-effective.* The borrower draws funds only as needed. Collections, made by the borrower, are credited daily as they are paid. New accounts qualify immediately as new collateral. (Though interest runs 3%–6% above prime, it's charged only on net daily borrowings.) *Result:* A revolving, self-liquidating loan, at a cost consistent with risk.

• *Credit expansion.* Besides receivables, the lender may finance inventories, real estate or any combination of assets. *Advantages:* For growth companies, much-higher-leveraged operations and greater flexibility.

Source: Robert I. Goldman, president, Congress Financial Corp., a factoring firm.

RECOVERING FROM A BANK TURNDOWN

Common mistake: Giving up after the first try. Instead, immediately prepare a new thrust.

What works:

• Asking for specifics on why the loan was refused. *Common causes:* The bank is overextended or doesn't know the company's type of business.

• Inviting the loan officer and one of the officer's supervisors to visit the plant. *Purpose:* To build confidence by showing off equipment, facilities and personnel.

• Soliciting ideas on how the application can be made more acceptable through financial or accounting changes, tax regulations, government programs or production changes.

• Applying for another type of loan or a different credit basis. *Possibilities:* Pledging machinery as collateral, using a third-party guarantee or borrowing against seasonal receivables.

• Reapplying when the timing is better. Use an upswing in sales or profits to obtain a line of credit or get close enough to the banker to be informed when the bank has excess funds to loan.

• Changing banks, particularly to one that is newly chartered and looking for customers. *Possibility:* Splitting a loan between the old and new banks.

• *Reminder:* The way the loan proposal is presented can be critical. A friendly banker will advise the company on which documents to present and the best ways to compile financial data.

Source: Finding Money: The Businessman's Guide to Sources of Financing by J.G. Hellmuth, Boardroom Books.

CAN'T MEET BANK PAYMENT?

Make an appointment to see the company's loan officer at the bank as soon as it is clear that the company will not make the payment on time. The officer can sometimes keep the company off the bank's delinquency list. *Benefit:* Preserves maneuvering room. Once an account is on the list, it comes to the attention of the bank's top officers. And that reduces the company's negotiating ability.

Tactics:

• Be honest. Withholding information only hurts in the long run.

• Do not wait for the bank to initiate a new payment plan. Bring one to the bank that fits the company's cash-flow projection. This preparation shows the company is sincere in trying to make good on the loan.

Be prepared to give the bank additional collateral if necessary. *Caution:* Do not strip the company of all collateral. Hold on to as much as possible so that management retains future bargaining power.

If the bank is uncooperative about negotiating new terms, shift the accounts necessary to manage the company's cash flow (everything above compensating balances) to another bank. Banks have the legal right to dip into a company's accounts to satisfy a delinquent loan. (It is called setting-off and can be done without notice.)

Bottom line: If the company's credit history has been good, most banks will work with management as long as they believe the delinquency can be cured. They do not want to lose customers any more than the company wants to lose its credit rating.

Source: Malcolm P. Moses, Malcolm P. Moses Associates, financial consultants, Merrick, NY.