Reorganization instead of Insolvency

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Summary: The article offers its readers practical recommendations and effective relations for getting the enterprise out of crisis.

The aim is to suggest the action that is to be taken in a situation of crisis. How can a manager and his subordinates cooperate efficiently? What means is every manager of an enterprise in crisis, recommended to resort to? How should an internal PR be used in anti-crisis management?

The problem is topical because of the fact that enterprises should be capable of dealing with a situation of crisis and of acting promptly, while truing to lose as little money, time, morale and public image as possible.

The practical research in this respect is insufficient. Neither is the number of books treating it.

Key words: crisis warning signals, strategy crisis, liquidity crisis, reorganization concept, crisis consultant, crisis management, crisis PR.

JEL: D74, D92, J33.

What is a convincing idea of reorganization?

Company crises are quite common. Dealing with them successfully is the chance and very often the starting point for a new stage in the development of the company and its stable growth. An ill-managed crisis can in the first place bring about total losses for business associates, staff, trading partners and creditors.

Company reorganization, as well as insolvency, is the result of crises.

Crises are part of economic development and a component of the emergence and termination of companies. The implication here is: Crises are a necessary element in the development of companies. Crises emerge when the inherently continuous process of adaptation is broken or slowed down and they manifest themselves in their final stage as existence crises with excessive indebtedness and insolvency of the company. Mismanaged crises can result in their spreading over whole concerns and, at the worst, in total loss for shareholders, business associates, staff and creditors.

Company crises do not appear "out of the blue", that is they are conditioned by external factors and they attack the company all of a sudden.

Experience shows that only an insufficient part of bankruptcies are really the result of external factors. The latter are often also used as an excuse (for instance poor economic conditions or economic problems). Experience shows that in over 80 % of the cases of medium-sized companies going bankrupt the decisive factor is internal circumstances[1]. These concern the management of the company, the human resources management, the production sales, the organization, investment, research and development, procurement, finance and controlling.

[1] Dr. Detlev W. Schlebusch, Crises in the Medium-sized Enterprises, publication, www.krisennavigator.com [8].

Crises never come "out of the blue". There is a maximum period of time to overcome the threat.

Crises in medium-sized companies – development, symptoms and ways of dealing with them[2]

Development of the crisis

In its development each company follows the stages in the personal and professional development of its management team by reflecting their assets and liabilities. And this becomes most obvious in the case of medium-sized companies, which are managed by their owners.

It all starts with a few wrong decisions that on the face of it, seem of minor importance. For example, in an attempt to cut expenses on staff the position of head of procurement is left open, after the previous employee has quit. Instead of hiring a new head, company management chooses to procure directly from workshops. Such mistakes that often go unnoticed or are corrected too late, can bring about adverse economic results: poorly controlled and expensive procurement, mismanaged orders, overstocking, etc.

Following the saying, "The chances and risks an enterprise faces are the result of its management" we should always look for the causes for a crisis at management levels. Quite frequently during economic growth and periods of prosperity almost no decisions or provisions are made here. This, later on, has negative consequences. In case the situation becomes difficult, and unusual, too, psychological barriers make it worse.

- There is a lack of communication and exchange of information with staff and workers.
- No creative discussions and no criticism pass.
- The different perception of circumstances leads to a further isolation from important business associates and, finally, to a strained separation.

Conclusion: The main reason for a company crises are most often connected with the personality of the president or owner of the company. The

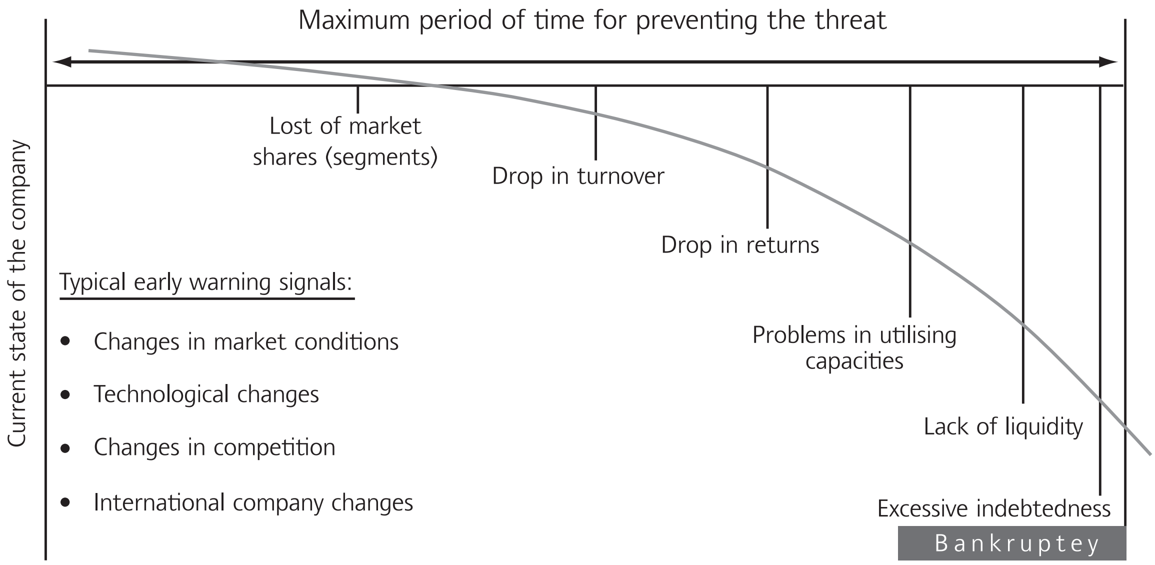

Figure 1. Crisis do not appear "out of the blue". They signal of their emergence in advance.[3]

[2] Schlebusch D., Unternehmenskrisen in Mittelstand, www.krisennavigator.com [7].
[3] Romer S., Sanierung von Unrernehmer auf Grunlage des INSO [6].

negative results, connected with the production, like a lower turnover, lack of efficiency, etc. are the result of earlier decisions.

Symptoms of the crisis

The threatening imbalance can be identified in time in the company itself, and in its external relations through the typical symptoms of the crisis. Together with the wide-spread methods of balance sheet analysis, suitable only for a partial evaluation of the situation, are used current results analysis, as well as practice facts that could predict a crisis.

Based on the above mentioned pattern of behaviour, company results often develop in

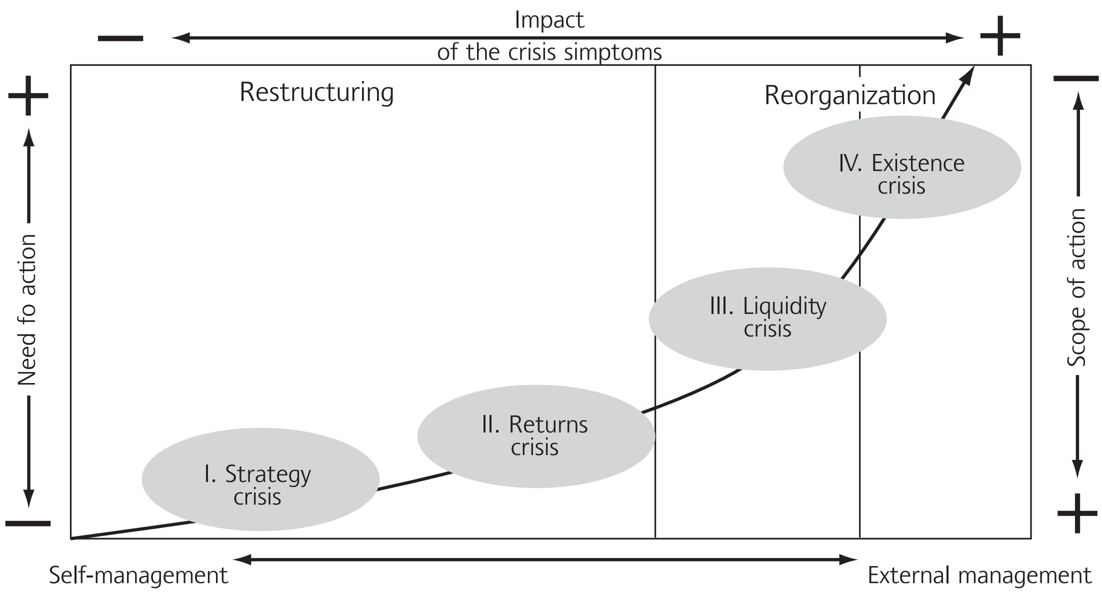

Figure 2. Narrowing the scope of action with the decrease of liquidity[4]

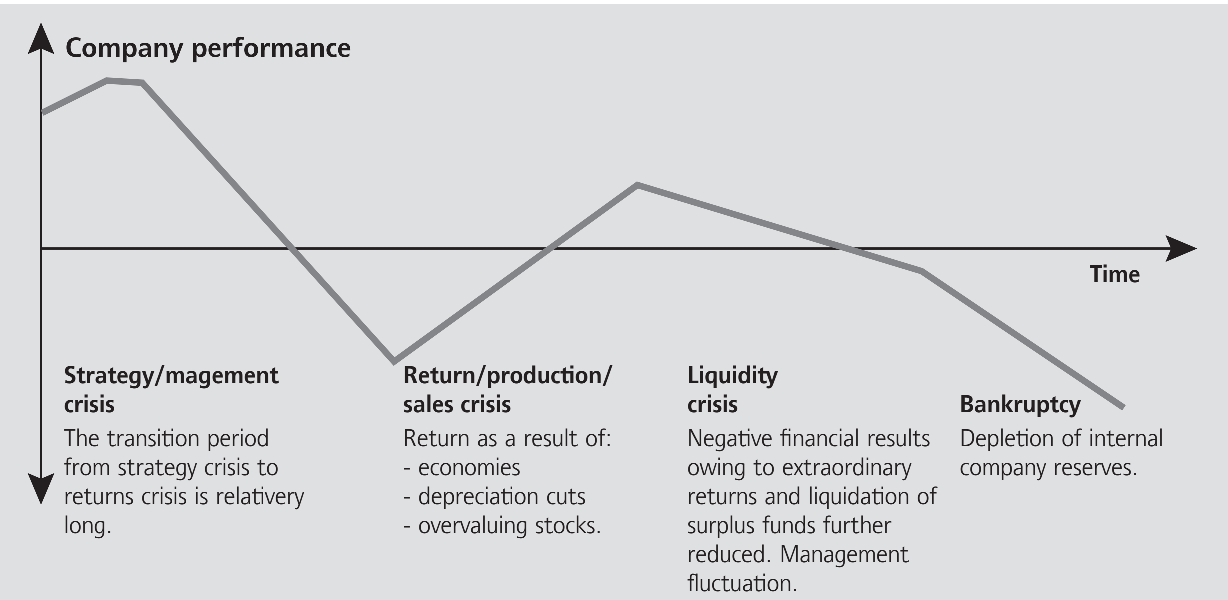

Figure 3. Company performance as a crisis symptom[5]

[4] Romer S., Sanierung von Unrernehmer auf Grunlage des INSO [6].
[5] Haushild, U., Diagnosis of the Crisis with the Help of Balance Sheet Analysis, Kioln, 1988 [4].

a typical way up to the point when the sharp imbalance starts.

After the first sharp drop in results follows a slight upturn as a result of utilizing the reserves and undertaking some superficial measures for cost cutting. Almost always this happens to the detriment of the necessary long-term factors for success and it results in additional using up of resources and property. A short, medium peak is reached, whereby reserves are depleted without any attempt at eliminating the real causes for the earlier deterioration. After reserves are fully depleted the lack of operation activities attacks the company severely and becomes the prerequisite for a bankruptcy.

The following presentation categorizes the typical shortcomings of the separate stages of company crisis.

Strategy crisis – returns crisis – liquidity crisis

Strategy crisis – unpleasant cool breeze

The strategy crisis is not a threat for your enterprise today and now but in the future. Changes in consumer behaviour or in population structure, novelties of market, legislation and politics influence the future opportunities for development of your enterprise. Your enterprise is in strategy crisis, if such factors that could threaten the enterprise are identified. For example:

- Big food chains and supermarkets made the small food stores almost disappear
- Who has his TV repaired nowadays? The drop in the prices of new household appliances made the repair in most cases not worthy the effort
- The building of a ring-road solves the problem with the noise for the owners of the adjoining plots but often leads to isolation of the small business in the center of the town/village

All these do not appear all of a sudden but give an opportunity for reaction: change of location, attracting new clients, continuing the development of own products and services, mergers – depending on the reason for the strategy crisis. If no measures are taken at this stage – the silent turning point – we are taking the shortest road to stage 2:

Returns crises – warning for a storm

Your enterprise is in a returns crisis when your profit or your turnover starts falling. Later on when your liabilities go up without this leading to investing money your first problem occurs. This is the period when you start communicating with your bank more often and begin facing difficulties in paying your open accounts when due.

This is when the crisis is felt directly and expressed in figures. At the same time your scope of action is noticeably restricted. On the one hand, the strategy trend should be corrected. On the other hand steps should be undertaken in the direction of costs reduction and processes optimization. If such measures are not undertaken or are not undertaken in time we are moving towards the next stage:

Liquidity crises – hurricane

Most people start talking about a crisis at this stage which is in fact the final stage. You can not pay your liabilities on time any more and the warnings for liabilities payment are piling on your desk. The bank is not ready to negotiate any more and the suppliers start procuring only against an advance payment. If no immediate measures are taken at this stage, the road to bankruptcy could hardly be avoided.

Could this concurrence of circumstances be avoided?

No, it could not! The returns crisis for example could be a result of unprofitable expenditure structure. A scandal, related to the "mad cow" could lead to unpredictable returns crisis as well. A force majeure could lead to an acute liquidity crisis. Statistics show that only a small part of the bankruptcies are a result of uncontrollable external factors.

Jump in turnover during a crisis

A cost cutting is usually the motto during a crisis. But the cost reduction helps only partially in cases when a company has a real turnover problem. Here we want to emphasize: If you want to save your enterprise you need higher loading of your capacities and higher turnover. If you are to reduce costs do not reduce those that contribute to increasing the turnover. Unfortunately, very often, the marketing budget is the first to be reduced, thus undermining higher turnover!

Turnover before the value of covering costs

When it gets too hot, we need more liquid funds. Staying on the market is the main motto. For each company most important of course are the products with the highest percentage of covering costs. But now it is a question of ensuring available stocks and what matters are only the sources of turnover means with a positive percentage of covering costs. This of course should not stop you from planning positioning products with high percentage of covering costs – but they will be sold more only if the company "continues breathing".

Check the argumentation of benefits

The periods of rising unemployment and deteriorating environment are namely the moments when the clients are very careful with the funds in their purses. The expenses on prestigious and luxury goods are often postponed for the future. Short-term and stable expenses, benefits, clients more than ever think of those. Check and rework if possible your argumentation of the benefits. Tell your clients for example how much money they will save with the new heating appliance the very first year instead of relying on argumentation like the low energy consumption.

Liquidity crisis – some emergency measures

If the liquidity crisis is already knocking on the door, immediate action is needed.

Supreme order: Ensuring solvency

You should be liquid or quickly become liquid. The cashing in on real estate or equipment for example takes some time – especially if we are aiming at gaining profit from the sale.

Cutting costs – raising returns – playing for time

- Check the due receivables and focus on their collection.
- Talk to the key suppliers – play for time.
- Check which costs could be reduced – not only in the company but in your lifestyle as well.
- Postpone investments which are not urgent.
- Check the possibilities for providing equity or long-term debt capital.
- The hardest part is speaking to the bank. As it is well-known a credit is given most readily when not necessary. But probably you have financed your investments by a current account. Then they are also repaid by a long-term credit.
- Focus all your efforts on sales. First address the clients with a high paying morale and then invest time and money (if available) in new clients.
- Concentrate on main competencies – this is not the time to experiment.
- Are your employees working to capacity? If you have spare capacities think of a way to use them for improving customer services.

Do you have employees?

Then involve them in this process. Ask your employees:

- What can be saved up – usually employees are well informed about the unnecessary expenses?
- How can the existing range of products and services be "spiced", in order to look better especially for the key clients?
- How can the customer services be improved?

You could motivate your employees to cooperate by indicating that:

- Everything possible will be done, in order not to cut jobs,
- The situation is complex but not hopeless.

Otherwise they will start looking for a new job and the best ones will be the first to go.

Overcoming a crisis

Reorganization ability – is the reorganization worth it?

Each reorganization is an investment decision, which should be well considered and investigated.

How should we go on? Should we go on at all? It is at this moment that people start thinking of reorganization. But the reorganization decision should be well considered and we should proceed step by step. Besides it should be checked how necessary reorganization is, whether a reorganization of the company is possible, is it worth carrying out, do we need a reorganization adviser.

Necessity for reorganization

First the question "Is it necessary?" should be answered. The necessity for reorganization does not come when we are threatened by insolvency or when the company is in liquidity crisis. Necessity for reorganization exists when returns fall for a long period of time (returns crisis) or when a new positioning because of changes in market relations (strategy crisis) is needed.

Possibility for reorganization

During an analysis of the current status it should be checked:

- To what extent insolvency, excessive indebtedness, respectively, of the company exists, whether they could be overcome in a short period of time;
- Whether enough funds could be collected for the reorganization process;
- Whether positive marketing prospects for the company products exist;
- Whether the company will be able to achieve an appropriate profitability in the future.

Are external funds needed for the reorganization purposes, will the creditors (for example creditors that forfeit part of their receivables) estimate the quality of the crisis management. The accompanying of the procedure by an experienced reorganization adviser helps not only the compilation and realization of the reorganization idea but also gives a sign to external participants for the seriousness of the efforts made.

The point of reorganizing

It is in the sphere of company reorganizing that we often hear talks that "good money" should not be thrown after "bad money". It should be formally checked whether there is any point in reorganizing, whether the value of the company returns is higher than the liquidation value. Creditors, as well as the new sources of cash will take part in the reorganization only if the prospects after the successful reorganization are better than the ones at the closing down of the company.

The opportunity for reorganization and the point in it often could be estimated only after the creditors have declared their readiness to participate in the process.

But not only creditors and sources of funds should be in a better position after the reorganization. These are questions that owners should ask themselves as well. If after the successive steps of reorganization a decent remuneration for the entrepreneurs and an adequate return of the risk and capital is not obtained, the above mentioned withdrawal should be planned. This, on the one hand, could happen either by closing down of the company or by a takeover of the company or by a management buy-out. The sooner the decision is taken, the bigger is the scope for action.

Is it still possible – do we want it?

Reorganization is not only expensive but it also takes more personal commitment, which often should be higher than during the stage of company establishment. One crisis does not come "out of the blue", thus a lot of independent entrepreneurs are physically and emotionally exhausted by the long futile struggle.

A question that the independent entrepreneurs are to answer honestly is: *Do I have enough intellectual and physical resources for a new beginning under complicated circumstances?*

Beyond management logic

A number of reasons interfere with the solid reorganization, the well-timed closing down, the temptation to go on without planning ahead. Apart from the typical suppression tools on the part of independent entrepreneurs or the corresponding managers, there exists an additional line of other reasons:

- The provision of own returns, lack of prospects for acquisitive deals
- The continuation of the tradition for example for family-owned companies to go on being so, just as they have done for years and family pressure to preserve this situation
- The sense of moral duty on a regional level and provision of one's own social status; especially in the rural areas where every single job matters a lot and where one s own social status is to a great extent determined by the part of an employer, reorganization is much harder to carry out.

No matter what difficulties you encounter, you must carry on. Any delay in reorganizing makes it more painful and more expensive as time passes. Of course, if there still exist opportunities and if there is a point in reorganizing at all. At the end of this sequence there often appears the threat of the company being declared bankrupt.

An advisor on reorganizing – do I need one?

The answer is short and obvious – yes!

There are at least three reasons for a crisis to deepen and to require an advisor:

1. You have not been able to recognize the symptoms of the crisis or have recognized them when it was too late
2. You have recognized them but you have not undertaken the adequate measures to overcome it
3. You have recognized the symptoms of the crisis, you know what measures would be adequate, but because of traditions and corporate culture you cannot undertake to prevent conflict

No matter which of the above mentioned reasons is valid, an external advisor is an important support in any event. The reorganization advisor is experienced at conceiving ideas of reorganizing and, in the first place, at negotiating with creditors. Not only will he give a technical expert opinion on the company but he will also act as an intermediary between you and your creditors, business associates and staff.

The reorganization advisor as an intermediary

Even if it hurts...: Company workers and staff have contributed to a great extent to the crisis. As is to be expected their suggestions of how to overcome the crisis are viewed skeptically. It is very likely they are also convinced that your creditors /a banking holding for instance/ and your workers /possibly through their insufficient willingness to work/ have contributed to the misery. Each one of the parties blames the other one for wanting to 'shelter its sheep from the rain '. These are poor premises to start negotiations and to put into practice the idea of reorganization. It is here that the reorganization advisor can step in as an intermediary. He has no other concern than the provision of available stocks for the company.

How shall I find the right reorganization advisor?

Gather the relevant information through your tax advisor, lawyer, friends' companies, the Chamber of Commerce. Talk with more advisors and choose the best one for you. Ask him the relevant questions:

- Ask him what course of action he is going to take. Find out if he offers an overall reorganization concept.
- Ask him about similar cases when the consultation was efficient, about the problems and their solutions. A serious advisor will never cite the names of particular companies. After all, you yourself would not want your affairs to be given publicity.
- Ask him if he offers a specific package of services and how much the latter will cost

Beware of conflicts of interest

For example if your tax advisor has supported you for years in reporting strong performance of your company, he is not the best crisis advisor. What he is going to do is recommend one of his personal friends who would not undermine his positions. Then you really have to start thinking of changing your financial advisor.

The most important thing is that your reorganization advisor should not have had anything in common with your company so far. Only then will he win the confidence of your creditors and employees. Otherwise the collective fault for the crisis will be attributed to him and he be blamed for pursuing his own interests. Building up trust is also an enormous task to be carried out on this particular stage.

Beware of offers not serious enough

Beware of effective offers in newspapers to help in situations of insolvency, especially when loans are promised without requesting information on your solvency. In your despair you are likely to look on them as the saving straw at which you could clutch. You had better look for a pillar as a straw would not be of much use.

Of course with your advisor you should lay a solid foundation for your discussions but be careful: he is going to state plainly what can be borrowed from the existing idea for company management and what has to be introduced and what is going to be dropped out.

Some of these matters will probably have a strong effect on you personally. But, finally, your ability to be taught and your capacity to face criticism will be of major importance where the existence of the company for another year is concerned.

Crisis PR: they are not meant for small to medium-sized companies?

Small and medium-sized companies often underestimate their PR. In cases of crises this could have fatal effects.

In the first place crisis PR has nothing in common with advertising. The latter is directed at certain groups of people and it represents the advantages of certain products or services. PR comprises the company in its integrity and its environment, for example the interested parties, the employees, the owners of the adjoining plots, political parties, etc. The crisis results in a disturbance not only in the customer relations but also in the relations with all groups in the environment.

When is crisis PR applied?

Crisis PR can be required, depending on the various crisis processes or critical situations like:

A crisis in the microeconomics, liquidity crisis

Disasters or accidents that could result in damages to people or the environment

Faulty products, campaigns to collect products with the aim of eliminating faults

Conflicts with particular groups in the company environment like the owner of adjoining plots or certain groups of interested parties

Disputes related to management

Does crisis PR apply to large companies only?

In a situation of crisis the company can easily find itself in the public eye which, at best, could be invaluable, particularly for small companies. And it may happen even if the company has not received front-page coverage in the media. The negative publicity local papers can give is no less significant than the one of club magazines and it can be as harmful for companies, operating locally. After all, on the Internet information spreads at a pace that one could hardly imagine a few years ago. So we should never forget the fact that crisis PR is the last thing that people or the environment need the moment they have just suffered actual damages.

And do not forget that the time after the crisis is just like the time before the crisis.

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