Financial Warning Signs – What to Watch for and What to Do

Here in Florida, the barometer plays an important role in warning us of stormy weather, even on days when the sun shines brightly and there is no obvious sign of rain. Unfortunately, when doing business with a company that may be heading into financial trouble, there is nothing as simple as a barometer to warn you. There are, however, tools and signs that can provide such warnings … if you look for them.

One of the results of the Great Recession from which we are slowly emerging is that companies are more aware of the need to be vigilant in protecting their finances by being careful of the economic health of their business partners. Another is that professionals in this area have learned various legal and financial methods of addressing problems earlier and in a more cost efficient manner. This article discusses some of those methods.

Warning flags to spot

First, it is important to understand your customer's business and the environment within which it operates. Companies falter or fail for a number of reasons. Social, economic, competitive, and technological changes can greatly affect a business. Similarly, government actions, mismanagement, and unexpected litigation can quickly change the company's fortunes. If you have a business relationship significant enough to affect your enterprise, pay close attention to factors that may hurt the other company.

It is a good idea to evaluate regularly the effectiveness and strength of management and make note of significant management turnover or dramatic changes in business strategies. For instance, family businesses sometimes have internal or generational disputes that can hurt the company and point to internal problems now or in the future.

Even explosive growth can be a danger sign. Think about all the horror stories we hear of lottery winners who end up bankrupt. Similarly, many companies do not know how to cope with sudden, dramatic growth and end up burdened with excessive debt and dangerous spending habits.

If you have more concrete evidence of problems, such as late payments or delayed performance of services, you might be able to dig deeper into the company's issues by reviewing its financial information. If it is a public company, this information will be available in its Securities and Exchange Commission filings and through search services. Many companies have investor relations sections on their website that also may provide useful financial information. In the case of private companies, the information is more difficult to obtain. If the business relationship is important enough, however, the company may provide them to you upon request. Alternatively, you can contract to receive such information when you enter into a significant enough business relationship.

When reviewing financial information, it is useful to view the company's performance over a period of time; do a trend analysis to see if the profits line is going up or down. Conduct an industry analysis by comparing your business partner performance with the average for other companies in the same industry. Then compare it with the dominant competitor in the same industry. This will give you a good indication of its strength.

To dig further, focus on certain areas of financial performance. An obvious area is sales and profits, with the emphasis on profits. Are they trending up, down, or staying constant? How long has it been trending that way? What accounts for the trend?

Another metric of a company's financial stability is liquidity. Having cash and other liquid assets on hand to meet current financial needs, or the unexpected cash need, is very important. Of course, the converse is also true. Insufficient liquidity is a serious danger sign that can give rise to covenant defaults in loan agreements and other financial stressors.

It is a good idea to take a look at the company's asset mix as well. A company that is property rich, but cash poor is vulnerable to even minor cash flow problems. You may have the nicest house on the block and a great year-end bonus coming, but if you can't pay the mortgage, you have a problem. Indeed, a buildup of inventory can be a danger sign. Although inventory is an asset, a lot of it may mean product is not selling and cash and accounts receivable are down.

It is prudent to monitor cash flow regularly. Is the company generating positive cash flow from its business? Is this a trend or a spike? Beware if cash is coming from one-time events, such as the sale of assets, instead of from operations. And it is worse if the company is selling income producing assets to meet short term needs. Note, however, selling assets that have a negative impact on the company's profits and cash flow may be a good business decision. A company that sells a non-core operation, say an overseas plant that has not been profitable, to improve cash flow and reduce overall debt may be acting prudently.

Finally, determine how the company is financing its assets. Is it through equity or debt? What is its debt-to-equity ratio? Does the debt seem excessive in relation to the value of its assets? What kind of return is the company receiving on its assets and equity? Again, look at the trend lines and see if they are going up or down.

What to do if you see warning signs

If the amounts in issue are large enough, you may want to retain a financial advisor to review the above information and advise you on the seriousness of the financial problem you have identified. You will need to determine whether the problem is temporary or long term.

You should also consider retaining legal counsel. There are various kinds of arrangements that can be reached with problem companies, ranging from simply monitoring the situation with access to continued financial information, to forbearance or workout agreements.

Other nonconsensual options include bringing suit, forcing a bankruptcy, or even participating in a cooperative bankruptcy. Decisions will have to be made as to who will bear the financial loss and how that will be done. An assessment must be made as to whether the company can survive and, if so, in what form. Should certain assets be sold? There may be a need for new management or perhaps the company should be encouraged to retain an outside consultant or advisor to help get its financial affairs in order.

In the end, there are numerous ways to protect your company from economic tempests … if you know what to look for, use the tools available, and get the right advice on how to navigate the storm.

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