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Signs of Financial

TROUBLE?

KNOW YOUR OPTIONS!

By David Ponting, CGA

Against all odds, TNT Gaming Technologies tossed the dice and rolled a lucky seven. Begun by a whiz-kid gamer in the basement of his parents' home, TNT enjoyed a winning streak of expansion despite its founder's disdain for budgets, balance sheets and business plans. Now the tables have turned. Two of its biggest customers haven't paid their bills in more than 120 days. The bank is slow in responding to repeated requests for an increase in TNT's operating line. Suppliers are demanding payment on their overdue accounts.

You were hired as chief financial officer of TNT. You were attracted by its growth story, but since coming on board you find its wheel of fortune broken. Your job is to make it spin again.

Is TNT Gaming Technologies on solid ground? Is it on the verge of a financial crisis? Given today's corporate climate of economic volatility and cut-throat competition, no CGA can take financial stability for granted. You need to recognize the signs of an impending financial crisis, and know your options. By seeking assistance at an early stage, you can move a company back onto firm financial footing.

Before exploring proposals and other remedies, let's look at some of the warning signs of financial troubles. In many cases, problems that may ultimately cause the insolvency of a business can be detected well before a crisis. If the danger signs are identified in time and corrective measures taken, the business may be saved. Such signs may include:

- Accounting records are consistently several weeks or months out of date.
- Cheques are returned by the bank marked "not sufficient funds."
- Government liabilities are increasing for overdue payroll source deductions, goods and services tax or retail sales tax remittances.
- Suppliers are demanding COD terms for goods or are cutting off supplies altogether.

- There is no followup of overdue accounts and aged accounts receivable listings are not prepared.
- The bank calls frequently to reduce an overdraft or to request financial information.

If your business is showing one or more of these warning signs, you need to implement corrective action—before the problems become unsolvable.

There are a number of remedies available to financially stressed companies. Your first step should be to contact a restructuring and insolvency specialist who can provide an objective assessment of the situation and recommend the best options. These professionals are typically licensed accountants, trustees in bankruptcy and turnaround professionals who have experience working with financially stressed companies. The earlier you call upon these professionals, the better the chances of saving your company.

To determine whether the business is salvageable, the specialist will assess the chances of the business's survival, identify appropriate options and develop a plan of action. He or she will look for answers to the following questions:

- Does the owner/management team have the commitment and capability of saving the business?
- How much is the company losing on a monthly basis?
- How long will it take for these changes to take effect?
- How will the financial losses incurred during the restructuring period be absorbed?
- What needs to change?

The assessment will provide a picture of the current business situation, its prospects and the best solutions for the problems.

Winding Up The Business

If the company was never profitable or has no chance of

profitable in the near future, closing the business is the only likely alternative. This would involve selling the company's assets—either through self-liquidation or bankruptcy—and distributing the proceeds amongst creditors.

Turnaround Financing

If the specialist determines that the core business is sound, it may be possible to refinance the company. This may involve, for example, factoring accounts receivable, selling non-essential assets, resolving disputes with lenders, and/or seeking additional sources of debt or equity capital.

The vibrant economic conditions of the past few years have generated huge amounts of capital in the lending markets. New lenders have emerged, and many U.S. funders are scouting the Canadian marketplace for investment prospects. It should be recognized, however, that the success of any financing strategy



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is dependent upon matching the financing to the purpose for which the funds are required. The wrong financing choice may lead to its own set of problems.

Senior secured lenders are traditional lenders such as Schedule A banks. These lenders are typically conservative lenders who lend on predictable cash flows with security backing. Their loan models are not as flexible as other lenders. Often they don't support distressed transactions. Conversely, they charge less and are the lender of choice for companies with normalized, predictable earnings.

Asset-based lenders are more interested in a company's saleable assets than stable profits. These lenders understand hard assets; consequently, they are more willing to finance a financially troubled company if that company has liquid assets and can meet reporting requirements.

Second secured debt is structured with a junior lien behind the senior lender on a borrower's assets. Mid-market mergers and acquisitions and an excess of capital in the markets have propelled these funders. This type of lending can be used in distressed deals when the primary secured creditor has not absorbed all of the security. This type of funding is expensive and can be difficult to attract given the associated risks.

Distressed funds tend to invest in specific sectors where they have expertise and experience. Some of these funds require that they take an active role in management as part of the lending requirement. They are typically used on deals larger than \$20 million and expect annual returns above 20 per cent.

High net worth/angel investors have significant personal wealth to invest. Usually they are entrepreneurs with considerable industry and management experience; some will require an active, full-time roll in the company as part of the financing arrangement. In Canada, this type of lender is often the solution for small and medium-sized distressed companies that need funds that are subordinated to the bank. In addition

to financing, these investors can add significant value to a distressed company through their personal record of success and strong financial contacts.

Restructuring and Filing a Proposal

If the company needs time to reorganize debt and/or to restructure operations, a proposal to creditors may be part of the solution.

A proposal is an arrangement with a company's creditors that is made under the *Bankruptcy and Insolvency Act* with the assistance of a trustee in bankruptcy. Basically, a proposal extends an offer to creditors, asking them to accept less than the amount owed to them, and/or an extension of time to repay debts. The trustee assists in structuring a proposal that is acceptable to both management and creditors. This negotiated compromise enables the company to restructure and continue operations. Creditors benefit by recovering more money than they would receive through a bankruptcy proceeding.

Proposals may also be beneficial for corporations that intend to liquidate operations. The process may preserve tax losses, public company listings, franchises, leases or other rights or privileges, which could be lost in a bankruptcy.

As a CGA, you know that obtaining early assistance for financially troubled companies such as TNT Gaming Technologies is your best bet in staving off bankruptcy. The numbers bear this out: according to the annual statistical report of the Office of the Superintendent of Bankruptcy Canada, the percentage of business proposals relative to the total number of business insolvencies continuously increased from 2002 to 2005. Businesses are simply seeking help at an earlier stage.

The odds of survival for financially-troubled companies like TNT Gaming Technologies are in their favour when the future is no longer a gamble.

TNT Gaming Technologies is a fictional company. The challenges and practical solutions presented are not specific to TNT.