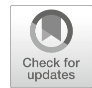

9 Negotiations in the Event of Financial Difficulties

Beautiful things can also be built from stones that are placed in one's path
Johann Wolfgang von Goethe (1749–1832)

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Summary

Companies in financial difficulties are in a crisis situation. The word crisis is a word with negative connotations and has something to do with danger and threat. According to the "Gabler Wirtschaftslexikon", crisis is defined as the most diverse manifestations or phenomena of an enterprise, from the mere disruption in the course of operations to conflicts to the destruction of the enterprise (Gabler Wirtschaftslexikon, Unternehmenskrise. Abgerufen am 26.5.2018. https://wirtschaftslexikon.gabler.de/definition/unternehmungskrise-49331, 2018). If a company is in an economic enterprise crisis, the functionality and stability can be impaired to such an extent that there is a threat of a company collapse—insolvency (insolvency). From the point of view of the affected company, these manifestations can be described as a financial crisis or catastrophe, which substantially threatens the continuation of the company and its existence (Gabler Wirtschaftslexikon, Unternehmenskrise. Abgerufen am 26.5.2018. https://wirtschaftslexikon.gabler.de/definition/unternehmungskrise-49331, 2018). The authors Krystek and Moldenhauer define three types of crisis for companies (Krystek, Moldenhauer, Handbuch Krisen- und Restrukturierungsmanagement, Kohlhammer, Stuttgart, 2007): non-existence-threatening crisis situation, existence-threatening crisis situation and existence-destroying crisis situation.

9.1 Signs of Financial Difficulties

9.1.1 Phases of a Financial Crisis

Companies in financial difficulties are in a crisis situation. The word crisis is a word with negative connotations and has something to do with danger and threat. According to the "Gabler Wirtschaftslexikon", crisis is defined as the most diverse manifestations or phenomena of a company, from the mere disruption in the course of operations to conflicts to the destruction of the company (Gabler Wirtschaftslexikon 2018). If a company is in an economic enterprise crisis, the functionality and stability can be so impaired that the danger of a company collapse, which means the insolvency (insolvency), threatens. From the point of view of the affected company, these manifestations can be described as a financial crisis or catastrophe, which substantially endangers the continuation of the company and its existence (Gabler Wirtschaftslexikon 2018). The authors Krystek and Moldenhauer define three types of crisis for companies (Krystek and Moldenhauer 2007):

- Crisis situation not threatening existence
- Existentially threatening crisis situation
- Existentially destructive crisis situation

Table 9.1 Reasons for company crises

Exogenous causes	Endogenous causes
Changing customer requirements	Management error
Economic changes	incompetence of staff
Socio-political changes	Inefficiency in processes
Governmental causes	Deficits in the area of production
Crises caused by suppliers	Owner-induced crises
Competitor	Lack of capital
Other external influences	Wrong strategy alignment

Own illustration based on Helmold (2018)

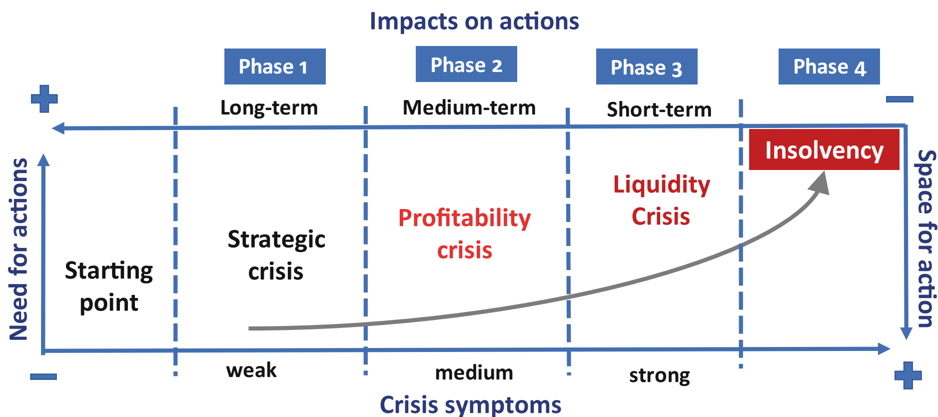

Fig. 9.1 Phase model of corporate crises. (Source: own representation based on Müller 1986)

Reasons for crises are manifold and can be divided into exogenous (external) and endogenous (internal) causes (Table 9.1):

One model for describing corporate crises is the four-phase model by Müller, who is a renowned scientist in the field of business administration and has published numerous papers in the area of corporate and financial crises (Müller 1986). In his model, he characterizes a total of four phases of corporate crises, as Fig. 9.1 shows. In his model, he assumes that the different crisis phases also require a certain period of time to find effective countermeasures to overcome the crisis. Müller calls the four phases the strategic crisis, profitability crisis, liquidity crisis and insolvency.

9.1.2 Strategic Crisis

At the beginning of a company crisis there is always the strategic crisis. This means that one or more strategic mistakes lead to a higher cost structure or declining revenues. This

can be, for example, changes in demand, increased operating costs or failure to take market changes into account. Strategic crises can be identified by an early warning system so that countermeasures can be taken.

9.1.3 Profitability Crisis

This is followed by the balance sheet crisis. In this phase, the crisis is already reflected in negative figures in the balance sheets or profit and loss accounts. Important features here are the decline in sales or the deterioration of the return on investment.

9.1.4 Liquidity Crisis

This is followed by the liquidity crisis. Phase 4 is characterized by the use of supplier credits, permanent utilization of the overdraft facility or even foreclosure. Up to this phase, the company can still recover by acting quickly and correctly, but not in the next phase of insolvency.

9.1.5 Insolvency

Phase 5 is insolvency or over-indebtedness. This is the beginning of insolvency proceedings. “Insolvency” means inability to pay. This always occurs when the debtor is no longer able to meet his payment obligations. This is usually the case when he no longer has the funds he needs.

9.2 Recommendations for the Elimination of Financial Difficulties

9.2.1 Restructuring

Most often, latent corporate crises slip through the perception system in the company, as they are very difficult to detect and do not yet send out strong signals. In the case of a company’s profit and liquidity crisis, it is obvious that there is a crisis because the key figures, profit and loss accounts or finances are clearly affected. In the case of weak signals of a latent company crisis, a crisis cannot be diagnosed so quickly, because the consequences will only be visible in the future. The significance of these weak signals is often underestimated and therefore they then develop into major problems. This also shows that crises cannot just occur suddenly, but develop slowly and gradually. Therefore, it is important for the crisis manager not to let crises become acute, but to recognize them early

in order to be able to act. It would be best to identify the crisis at the stage of potential crisis, as this could prevent a crisis.

Early warning systems are of great importance when it comes to perceiving crises. Early detection or early warning is not only used to identify threats and risks to the company, but also points out for opportunities and chances that this may present to the company. Some early warning concepts are ratio analysis, financial statement analysis, and forecasting and portfolio techniques. Constant checks and balances within the company are part of the process. Various methods help in making better and effective controls. The most common ones are liquidity control, profitability control, equity investigation, SWOT analysis and value in use analysis. These methods encompass the entire company and its environment, therefore it is easier to identify negative influences. This book will not go into detail on how to handle each method, but early warning and its methods are important for crisis management in business management. The most common early warning methods are ratio analysis and financial statement analysis, which reveal important facts for the company. Here, accounting provides the necessary basic data and data external to the company is included. In ratio analysis, the entire ratios, such as equity or debt, are analyzed and a balance sheet is created. In this balance sheet, the profits or losses become clear and it can be seen whether the company is in danger or not.

9.2.2 Measures to Increase Liquidity

9.2.2.1 Immediate Measures

In the following, measures for bridging financial bottlenecks will be presented on the basis of the balance sheet Fig. 9.2 and the income statement Fig. 9.3. The measures can be divided into those that increase cash and/or short-term receivables and those that reduce short-term liabilities. In this context, it is crucial that the measures are implemented immediately, otherwise liquidity bottlenecks will lead to insolvency. Figure 9.2 shows the simplified balance sheet with the assets and liabilities side. On the asset side, financial resources can be booked through different steps in fixed or current assets, whereas on the liability side, activities in equity or debt (increasing equity through equity providers or rescheduling debt through negotiations with the bank) are necessary to eliminate a financial crisis (Olfert 2013, 2015).

9.2.2.2 Equity Increase

One step to improve liquidity immediately is the use of new funds by the shareholders or equity investors (Olfert 2013, 2015). With a capital increase through cash contributions, liquid funds are injected into the company, which can be used to repay due liabilities. However, it should be noted that the shareholders only agree to a capital increase as long as the earnings prospects of the company are positive and the shareholders can expect a return on their contribution in the form of a dividend, which is usually higher than the interest rate for debt capital (Olfert 2013, 2015).

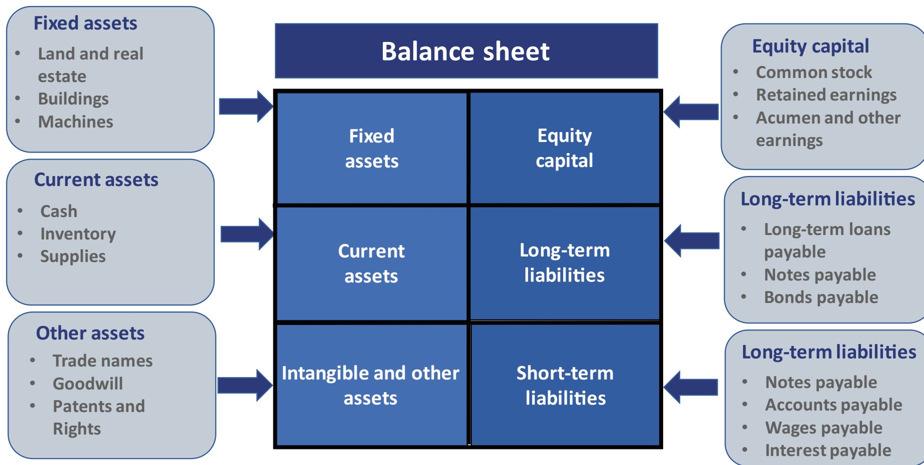

Fig. 9.2 Effects on the balance sheet. (Source: own representation)

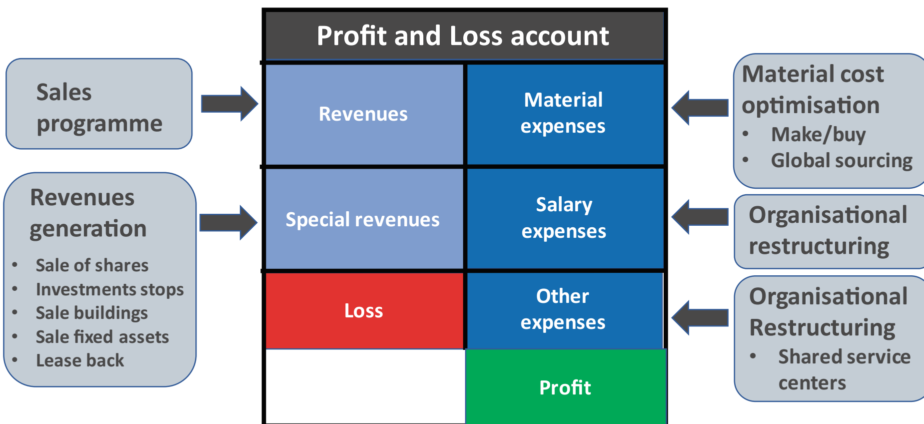

Fig. 9.3 Effects on the profit and loss account (P&L). (Source: own representation)

9.2.2.3 Increase in Long-term Liabilities

Another step is to increase debt capital (Olfert 2013, 2015). A company's liquidity can also be improved in the short term by taking out long-term loans to repay short-term liabilities. However, it should not be overlooked here that this measure is only suitable for a short liquidity squeeze, as the payment problem is merely shifted into the future (Olfert 2013, 2015). It should also be noted here that creditors are only willing to grant new loans to a company with liquidity difficulties if the company's earnings prospects are positive (Olfert 2013, 2015).

9.2.2.4 Sale of Fixed Assets and Leaseback

A popular method used by companies is the sale of fixed assets. To improve liquidity in the short term, it is possible to sell fixed assets (usually land and buildings), which are then leased back (so-called "sale-and-lease-back"). The sale leads to a high inflow of cash, while the payments for rental expenses are shifted into the future (Olfert 2013, 2015).

9.2.2.5 Factoring

The liquidity effect of the sale of receivables (so-called factoring) must be viewed in a differentiated manner. While the sale of receivables increases first-degree liquidity, it has a negative effect on second-degree liquidity. Although the sale of receivables increases the cash position, the receivables position is reduced at the same time. Since the factoring bank retains a discount on receivables for its financing function, the increase in the stock of cash is less than the decrease in the stock of receivables, so that the second-degree liquidity decreases (Olfert 2013, 2015).

9.2.2.6 Inventory Optimisation

Another activity is the reduction of inventories. A high level of inventory leaves particularly inventory-intensive businesses groaning under the cost burden. For example, a lot of warehouse staff is needed, which quickly adds up not only the expenses for wages and salaries, but also for ancillary wage costs. In addition, extra costs are incurred for personnel administration. But the storage facilities themselves also generate costs for rent, energy and water, maintenance, loss of value of the equipment, expansion of the storage facilities, interest on invested capital, insurance and cleaning. A high inventory level itself also creates burdens that are not yet taken into account here. Immense amounts of dead capital, the interest accruing on it and a lack of liquidity result in further high losses. And of course, insurance premiums are also incurred for the goods, be they finished or intermediate products. In addition, however, factors that are hardly tangible should also be considered. Spoilage, overstocking, obsolescence, damage, enormous inventory effort and theft—all these losses can be quantified in a rough approximation at best. Worse, further expenses can result from any of these components. Video cameras because of thieving colleagues or suppliers, extra work in plant security, sickness costs due to an above-average number of employees under heavy physical strain—the list goes on and on. In such a situation, there is a constant danger of losing track of expenses. A high level of inventory carries serious risks that can unexpectedly put even successful companies in a precarious position.

9.2.3 Measures to Reduce Current Liabilities

9.2.3.1 Conversion of Debt Capital into Equity Capital

By converting debt into equity, the company no longer has to make the repayments due. Here too, the existing creditors will only agree to this project if the earnings prospects are positive. The disadvantage for the company is that dividend payments must be made in the future and that the previous creditors now have a say in the management (Helmold and Terry 2016).

Table 9.2 Negotiations and actions in case of financial difficulties

Recommendations for negotiations in a precarious financial situation
Sales programs
Opening up new markets
Liquidity improvement plans through advance payments from customers
Increase in contributions from equity investors
Negotiation with lenders
Adding new investments
Liquidity improvement plans by extending the payment terms of suppliers
Cost-saving programs
Renegotiations with all suppliers
Supplementary claim management
Process improvements
Inventory minimization through the introduction of Vendor Managed Inventory (VMI)
Divestment of non-vital divisions
Closure of non-profitable plants and business areas
Discontinuation of non-profitable lines of business
asset disposal
Global sourcing activities

9.2.3.2 Debt Rescheduling

Liquidity can also be improved in the short term by rescheduling short-term liabilities into long-term loans. However, here too the payment problem is merely shifted into the future.

Table 9.2 summarises the recommendations for negotiating with different stakeholders in the event of financial distress.

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