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Is Today a Good Day to go Bankrupt?

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When to file for protection under the Bankruptcy Code is a difficult question to answer, but in this case, timing is important. At the risk of oversimplifying the question, deciding to seek protection under Chapter 11 can be a wise and prudent step when it is determined that it is the best way to maintain regular operations and allow for a successful restructuring. In other words, Chapter 11 is a sensible option when it provides the best chance for survival.

If a corporation (whether for-profit or tax-exempt) waits too long to file under Chapter 11, the chances of a successful reorganization becomes less likely.

Chapter 11 basics for corporations

Generally, under Chapter 11, the debtor remains in control of its business as a "debtor in possession" and is subject to the oversight and jurisdiction of the court. The court can allow complete or partial relief from most of the corporation's obligations and contractual commitments. Thus, Chapter 11 can enable the corporation to emerge as a viable going concern.

However, if the corporation is not viable or if the reorganization plan does not work, the business will simply be liquidated under Chapter 7 of the Code. Under that scenario its owners and unsecured creditors will probably be left with little or nothing, and its employees will find themselves out of work.

Problem signs

The examples that follow may, individually or collectively, cast significant doubt about an organization's ability to operate as a going concern. They are listed in no particular order.

1. Negative equity
2. Negative operating cash flow
3. Adverse financial ratios
4. Substantial operating losses
5. Significant reductions in income producing assets
6. Excessive reliance on short-term debt to finance capital assets
7. No realistic plan to refinance maturing long-term debt
8. Inability to pay creditors within due dates
9. Inability to comply with loan covenants
10. Vendors' demands for cash-on-delivery
11. Loss of vital management personnel
12. Loss of major customer, market, franchise, or license
13. Loss of primary supplier
14. Labor difficulties or shortages
15. Lack of financial plans, forecasts, budgets or projections

Problem signs continued:

16. Concentrations of risk with regard to revenue sources
17. Inadequate or underperforming information systems
18. Lack of adequate insurance to cover disaster related losses
19. Lack of resources to pay pending claims against the entity
20. Legislative or regulatory changes that may have adverse material effects
21. Excessive pressure of a leading competitor
22. Obsolescence of a key product or service
23. Business failures of others in the same industry
24. Deficiencies in the governing body

If you prefer a more quantifiable measure to predict the degree of distress of a particular company, then consider the **Altman Z-Score**. The model uses common business ratios applied to certain weights to predict whether the company will fail within two years. When used properly, the model has been proven to be 70% to 90% reliable.

*For a limited time and on a confidential basis, we will entertain engagements to compute your organization's Altman Z-Score **free** of charge.*

Most businesses – including successful businesses - face problems from time to time. The key is to recognize the problems and implement plans to mitigate their effects.

Rolling business plan

It's important to recognize the problems early. This requires foresight, instincts, intuition, and a continuous business plan. We believe that all businesses should forecast their operating results and cash flows on a rolling 24-month schedule. The forecast may enable management to recognize potential negative trends so management can make appropriate operational adjustments.

We believe that the rolling 24-month forecast should be maintained in good times and in bad. If one waits until one begins to realize the effects of a downturn, it might be too late to fix the problem.

The 24-month forecast starts with the identification of the significant assumptions and key business indicators that can influence your organization's operating results and cash flows. Then, based upon those assumptions and indicators, the forecast can be prepared using readily available computer modeling software.

On a monthly basis, actual operating results and cash flows may be compared to forecasted amounts, differences may be evaluated, and assumptions about the future may be reconsidered. Then the 24-month forecast can be updated and rolled forward to reflect the changes. Moreover, using computer modeling software, one can ask "what if" and easily compare the results of alternative assumptions.

The rolling 24-month forecast should be viewed as a live planning tool, not a fixed prediction from a single – and stale - point in time. If used properly it can bring to light potential negative trends and enhance the quality of solutions.

The decision

Chapter 11, though drastic, might be an appropriate option that could mitigate the effects of a corporation's fiscal problems.

It should be noted, however, that a Chapter 11 reorganization is very expensive. The legal fees alone can be significant. Thus, delaying the decision and burning through cash reserves with the hope of a turnaround could deprive the corporation of the Chapter 11 option, leaving liquidation under Chapter 7 as the only alternative.

This paper does not imply that Chapter 11 should be the first option. Nor, does it imply that Chapter 11 should be near the top of the list. We suggest only that it should be on the list.

Surely, we hope that you are never faced with the decision to go bankrupt. While it is understood that there are unavoidable risks in every business, under the right conditions reorganization under Chapter 11 can be a lifeline.

How to minimize the risk of bankruptcy

Of course, the best approach is to minimize the risk of bankruptcy. While that may be easier said than done, a few pointers (though incomplete) follow:

- **Little things** - The old adage, "Don't sweat the small stuff" does NOT work in business. Small problems, if left unattended, can turn into big problems. The point...if you sweat the small stuff, you may never have to consider the Chapter 11 option.
- **Planning** - Another maxim does indeed apply - "Those who fail to plan, plan to fail." Here, the rolling 24-month forecast will address this issue.
- **Advisors** - Generally, business is too complicated for one individual to know it all. So it's best to surround yourself with trusted and qualified advisors. And, you should encourage dissent...*yes men* only serve the CEO's ego.
- **Follow up** - Keep your eye on "the ball." Stay focused on the core business. Success generally cannot be achieved with a part-time effort. Accept the fact that sometimes you have to do the things that you dislike or that might be less than exciting. Don't rely on middle management completely. Follow up and measure progress.
- **Growth** - Although, marketing is vital, business growth must be controlled and managed. Again, the rolling 24-month forecast can help.
- **Regulatory compliance** - Pay attention to regulatory compliance and new developments. Government at every level will continue to grow and impose new and burdensome requirements. The failure to maintain compliance can result in unfavorable consequences. Under certain circumstances, noncompliance can result in business failure.
- **Fixed burdens** - Keep your fixed outlays manageable. Revenues can increase or decrease depending on factors beyond your control. If your debt burden is too high, a downturn in the economy can easily cause the business to fail.
- **Balance sheet** - Assuming your books are maintained on the accrual basis of accounting, don't forget to read your balance sheet every month. Failure to monitor changes in receivables, payables and other accruals can result in unfavorable surprises. If you don't maintain your books on the accrual basis, you should. If advantageous, it might be possible to maintain your books on the accrual basis but use the cash basis for tax purposes.

Here's hoping that you never have to ask, "Is today a good day to go bankrupt." Unfortunately, hope alone may not be enough. ***Success must be earned.***

For more information or to learn how we can help you succeed give us a call.

Have a great holiday!

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