

Cooney Carey has significant experience in corporate recovery and business structuring. Armed with the opinions from senior managers in near all the “difficult case” departments in the banks operating in Ireland, along with input from insolvency practitioners, we have listed and commented upon the most common causes of business failures.

Awareness is the first step in prevention or remedial action. Our comments will provide insight into the major difficulties currently being experienced. What to do about them depends on the extent of the business’s situation and the skill set available to it. If the problem is significant specialist advice should be sought.

1: FINANCIAL

1:1 Lack of Cash and Cash Management

Generally the main trigger that causes failure is the lack of cash rather than the lack of profit. Business can hold out for a period whilst making losses – eventually however those providing credit (bank or creditor) will take action and withdraw or restrict credit. This problem is most significant in the current market where banks are reducing overdrafts and insurers are withdrawing debtor covers. A more immediate issue is where the business is unable to pay costs such as wages where no credit is available. Inefficient management of debtors, creditors and stock positions will absorb cash and give rise to an increase in a company’s borrowing requirement.

It is critical to manage cash flow on a day to day basis. Knowing exactly when cash is likely to come in and from whom – then balance that with a planned payment programme. Businesses that run out of cash or do not stick to payment plans lose goodwill very quickly. Understanding cash flows and managing customers and suppliers expectations is absolutely vital in this downturn.

1:2 Lack of Equity

Very many new businesses are under capitalised and rely on debt or creditor credit to fund the business. Neither of these sources are risk takers and if the risk is judged to be too great, the facilities are withdrawn. Businesses need to source equity at the outset or as its circumstances change in order to ensure continuity and that reasonable risk can be taken in developing or continuing the business. It is not recommended that equity is replaced by personally securing debt – equity and debt should be kept apart.

Be sure to utilise the correct type of debt, in times of growth Invoice Discounting can be the perfect method, however when falling sales are falling Invoice Discounting sucks cash out of the business. Match repayments on a term loan or equity payment plan to annual seasonality and long term business planning.

1:3 Inappropriate Financial Management

Inappropriate financial management is a common cause of failure and is usually evidenced by excessive levels of debt relative to a borrower’s cash generating capacity, the cyclicity of the industry within which it operates and the flexibility inherent within its cost structure in the event of an unforeseen downturn.

Insufficient gearing may also be deemed to be inappropriate financial management in certain circumstances. Whereas a highly aggressive financial policy can lead to the development of a rapid crisis situation, an overly conservative financial policy may result in insufficient investment in the business and cause a prolonged period of decline leading, ultimately, to the failure of the company.

An unsuitable structure for the company's debt in terms of its maturity or currency profile, for example, also evidences inappropriate financial management as does an inefficient or non-existent risk hedging strategy.

1:4 Inappropriate Capital Expenditure

Capital Expenditure should not be avoided, but a critical analysis of "pay-back" period should be undertaken. The expenditure producing the quickest pay-back is usually best in the current environment.... "cash is king".

Companies are driven to undertake major capital expenditure projects as they strive to achieve organic revenue growth. Big projects go wrong because costs are underestimated or revenues are overestimated.

A feature over the last number of years has been for businesses to acquire their own premises. This was seen as the means of creating wealth, whereas the business itself was the producer of earnings. The equity needed to fund the premises purchase would have been extracted from cash flow / working capital. In the current market loan repayments are likely to be higher than rent payable. The double effect of reduced working capital availability and higher fixed costs is a major cause of business failure.

1:5 Lack of Financial Control and Information

Lack of adequate financial control and, on occasions, creative accounting, is evident in companies in distress. In smaller companies, cashflow forecasting systems, costing systems and budgetary control systems might not exist. Similarly, key performance indicators, customer profitability and product profitability may not be monitored. In larger companies, the problem is more likely to be inadequate or overly complex systems rather than non-existent systems. Management needs relevant, timely and accurate information to assist it in the management of the business.

Reliance on Annual Audited Accounts is inadequate – an audit is produced at year end and is usually available six months after that year end. The statutory layout of audit accounts can be inadequate, particularly for manufacturing and service industries. Current information is essential in order to facilitate effective decision making. Treat your facts with imagination – but don't imagine your facts. We recommend that business establish what the key variable drivers are (KPIs – Key Performance Indicators) and report quickly, at least monthly, on same (Flash Report). Sales, Gross Profit and Wages are usually key, whereas Rent, Rates and Insurance do not vary within the year. The Flash Report should be supplement quarterly with a full set of accounts and analysis. If decision are however critical, then Flash Reports will not be adequate, they are an indicator.

Banks are far more forensic today and require quarterly management accounts for most medium sized business.

1:6 Lack of Cost Control

All costs, whatever the state of the economy should be closely monitored and controlled. Cost cutting should be strategically viewed, be careful of cutting costs in areas that are critical e.g. sales. Take the hard decisions and cut in areas that are underperforming rather than the easy targets.

A company which has a substantially higher cost base than that of its major competitors is likely to be at a competitive disadvantage at all times.

Companies with higher cost bases will earn lower profits. As a result, these companies will generate less free cashflow and have less borrowing power. With less funds available to them than their competitors, they will not be able to invest as much on product development or marketing and they will not be able to commit to fixed capital investment to the same extent as their major competitors. They will be less capable of building and defending their market position. High costs also limit a company's ability to compete in terms of price.

2: TRADING

2:1 Overtrading

Companies can be too successful in generating sales orders and this can result in an unsustainable cashflow position. If sales grow at a faster rate than can be financed from internally generated cashflow and available bank borrowings then the business quickly runs out of cash.

Overtrading occurs when companies pursue sales growth. Margins are cut to generate sales and sales volume increases at a time when the company does not have access to sufficient sources of external funding for the increased level of business. In growth companies, sales volume is clearly a critically important factor. But when companies get into distress, there is a renewed focus on sales volumes, often at the expense of gross profit margins. This can exacerbate cashflow problems.

2:2 Costing and Pricing

It is essential to know the real cost of producing your product or service. Know what price to set, when to change this price and avoid under-costing - this requires a combination of information and judgement. If prices are too low expenses will not be covered, if prices are too high sales will be lost.

Don't chase Turnover in this market and indeed use such an exercise as an excuse not to cut costs. There are plenty of examples of businesses dropping prices to maintain turnover but at lower margins which are not sustainable. There is a need to be brave, to not go beyond a level, stay in business, and when the low cost operators have gone bust, you will be around to pick up the business at a price that is profitable.

Avoid the temptation to simply cut cost and compromise quality, such an action will damage the long term viability of the business and make it most difficult to recover customers when the market recovers.

2:3 Commodity Price Movements

Whilst not classed as “Over Trading”, similar problems arise in sectors that purchase or sell commodities such as grain or steel. Commodity prices are items over which management has no control and which can fluctuate widely, often over a relatively short period of time.

As the cost of commodities rise a well-run sales function will pass this price onto customers, profitability is maintained, however the value of creditors, debtors and stock can dramatically rise and thereby creates an increased need for working capital.

A problem also exists in over stocking commodity items, a turn in the market price can result in significant stock losses (or gains).

2:4 Market Changes

Reduction in demand or changes in the pattern of demand can be important causes of distress. A drop in demand may be a long term trend resulting from changing consumer tastes and social norms or technological developments. A drop in demand may also be a cyclical decline resulting from the regular economic cycles of boom and recession. Seasonal decline in demand is not significant as a cause of failure except when a company is in a weak financial position.

Demand for a particular product may not decline but the way in which it is distributed and purchased may change. An obvious example here is the emergence of the internet as a distribution channel. The growth of out-of-town shopping centres is another example.

Both product competition and price competition within a market are common causes of decline. They often occur together and are usually compounded by the dynamics of industry competition.

Companies may be slow to develop new products because new product launches have not historically been successful, there is a complacent and misguided belief within the company that the old product is still the best on the market, financial resources to develop new products are inadequate, there is not sufficient technical know-how within the company to develop new products and there may even be a fundamental lack of creative ideas for new products.

Severe price competition has been an increasingly common cause of decline in manufacturing industries in recent years as manufacturing has migrated to low cost countries to maintain margins in the face of vigorous price competition.

Industry dynamics are another significant source of competitive market pressure. Those companies which have a sound market focus and sound product focus, good product differentiation and a low cost structure are going to perform better in the industry than are their competitors. Companies which are not able to compete in these areas are destined to failure.

2:5 Industry Failure

Examine the industries and sectors you sell into. If they are in difficulty then an over reliance on them will result in difficulties for you also. Specialisation is a good means of marketing your business, but beware of become over exposed. In the current market those associated with property transactions are in difficulty, previously those associated with tourism incurred problems.

2:6 Small Customer Base

Beware of over reliance on a small number of customers. If they go - you go. Broaden your base of activities to avoid relying on one or two large customers or suppliers. The success of the business should not be dependent on one or two people outside the control of the business.

A good business strategy will seek to develop new industries and new customers. There are four segments to such a sales strategy. The easy strategy is based on selling old products to old customers – the more rewarding, but challenging strategy is in selling New Products to Old Customers and Old Products to New Customers, this latter strategy ensure that the business is always developing.

- Old Products to Old Customers
- New Products to Old Customers
- Old Products to New Customers
- New Products to New Customers

2:7 Inability to Sell and Market

During boom times a business can survive without adequate selling skills. When demand outstrips or just meets supply poor businesses can flourish. However when normal times return, or indeed difficulty times prevail selling skills and sales management procedures are required – the lack of them is exposed and failure can quickly follow.

Management of the sales process involved setting a realistic budget, allocating responsibility for its achievement and concentrate monitoring on reducing the GAP between budget and committed sales.

Companies in decline often exhibit signs of complacency. Nowhere is this apparent more often than when it comes to marketing. Common shortcomings include a lack of responsiveness to customer enquiries and poor after sales service, a poorly motivated sales team, an ineffective advertising spend, a lack of market research and poor product development.

3: MANAGEMENT

3:1 Lack of Management Skills and inappropriate structures

Management is a talent and a skill set, constant updating and training is required. Care must be taken to recognise that management might not know everything. For specific issues, where the knowledge is not available in-house, experienced advisors are essential. Management should be capable in managing the day-to-day activities, have a capability to design and implement strategy, but also to know its limitations and seek advice where needed. During periods of growth people have been promoted beyond their skill set, businesses have been created by people not capable of managing them – example many (say) carpenters established businesses during the property boom as the business grew the carpenter became the managing director – thereby removing the best carpenter from the business and installing a poor manager.

The management function should not be compromised by filling vacancies with persons lacking the necessary skills required. Internal promotion may be the safe option, but if the skill set is missing the business needs the courage to source externally.

Lack of confidence in delegation can result in the principal trying to do everything including getting involved in relatively unimportant aspects of the business which can result in neglect of the business essentials.

Structural defects include the presence of a dominant and autocratic CEO, a combined Chairman/CEO role resulting in insufficient challenge to the CEO, an ineffective or unbalanced board of directors and a lack of management depth within the company.

Distressed companies are often characterised by organisational inertia and confusion. They are not able to make or implement decisions as a result of poor leadership or a poorly motivated workforce, poorly defined accountabilities and responsibilities and inappropriate organisational structures and management processes.

Any signs of a lack of consensus among the management team or neglect of the core business also evidence significant management weaknesses.

3:2 Inability to Adapt

Sentiment and nostalgia can influence decision making - very often unprofitable customers / products / markets are pursued when they should have been dropped a long time ago.

If part of the business is going down the tubes know the right time to exit and concentrate on new parts of the business. The temptation to hang in too long will result in larger losses.

Some businesses are unwilling or unable to adapt to modern practices whether it is marketing / production / technology etc and this can very often lead to them falling behind their competitors.

3:3 Internal Culture

Times are tough at the moment, but as always there is a need for the culture and internal atmosphere in the organization to be right. Staff need to be motivated to be positive and to succeed. Without this motivation it is difficult to see how the business can positively interact with its customers and suppliers.

3:4 Inability to Communicate with key stakeholders

Trusted relationships and good communications with banks, trade insurers and creditors are an essential prerequisite in order to elicit their positive reaction toward the business if help is needed.

Bank and creditors are quoting instances where businesses behaved in an unhelpful and provocative manner in “the good times” and now that they need a sympathetic ear this is not forthcoming – the credits were not built up.

If a Bank feels that the business is untruthful (or not telling it what it feels it should know), the bank will likely lose faith may look to disengage.

3:5 Lack of Objectivity

It is always helpful to “bounce” ideas off advisors and confidants. The appointment on non-executive directors can be most beneficial.

This objectivity would address issues such as over gearing, over optimism, lack of confidence and risk (‘stick with the knitting’ many times is best)

3:6 Excessive Personal Drawings

A proprietor and his/her family living beyond their means is a threat to a business - this is a problem that most family businesses suffer from. Personal drawings should not exceed profits under any circumstances. The prudent businessperson should ensure sufficient profits are retained in the business for future developments.

Conclusion

With proper insight, planning and implementation the risk of failure can however be reduced, but not eliminated. There is no guarantee of success in business, however failing to plan is effectively planning to fail.

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