

Avoiding corporate collapse

- **How companies collapse**
- **Bad management practices**
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How Companies Collapse

Business failure rarely happens by accident. Companies drift rather than fall into collapse.

Drifting into collapse

Businesses may collapse rapidly, but they fail gradually.

Close monitoring of a company's business health can help directors (and others) identify potential failure early, so remedial or rescue action can be taken.

At the very least, the effects of failure can be mitigated. Within many failed or failing businesses, there are elements that may be saved.

Bad management

The prime cause of company failure and collapse is 'bad management'.

It's difficult to obtain agreement on how to define or recognise bad management. Nonetheless, after collapse everyone will agree on how badly a company was managed.

Hidden signs

Company directors, employees, investors and bankers often demonstrate an inability to see failure until it's too late; and they're rarely alone in their restricted vision. It's common to find optimistic reports written or published by independent accountants and other advisers only months before a company's collapse.

The signs of imminent collapse are easy to conceal and difficult to recognise. It depends on who is looking, where they look, why they are looking, what they are trying to find out, and the extent of the investigation.

Bad management practices

Autocratic rule

Sooner or later, autocratic chief executives encounter a series of events which they do not understand, and about which they will not accept guidance. Failure will often follow.

An autocratic managing director may impede effective decision-making in areas where he or she lacks strength or experience.

Often, having brought a company from a start-up situation, the same person may also have difficulty making the transition to the next stage of growth.

A non-participating board

Autocratic leaders can only cause damage if they are allowed to do so by a non-participating board.

Non-executive directors must insist upon exercising their powers and fulfilling their responsibilities. They must also demand and receive regular, detailed, reliable and timely information.

Lack of leadership

On the other side of the coin, some businesses fail because they lack an effective chief executive to provide overall control and direction.

With weak leadership, middle managers may fail to focus on the company's core business. The potential for conflict within the company also increases.

An unbalanced top team

Many failing companies lack management depth, especially in the area of finance.

An insufficient range of management skills, coupled with a reluctance to consult outside advisers, is a recipe for disaster.

A weak finance function

Often the finance and accounting function is intentionally under-resourced.

Senior managers are starved of accurate, relevant financial information. Budgets, cash flow forecasts, costing systems and other internal control systems may also be inadequate.

Inadequate industry knowledge

Many failed companies have had senior executive managers who possessed inadequate strategic understanding of the industry and the specific business environment.

Nepotism

Family members may retain management responsibility, regardless of their suitability.

This not only gives rise to bad management practices, but it may also reduce the company's ability to attract and retain experienced 'non-family' managers if they are unable to aspire to senior positions.

Uncontrolled growth

Rapid business growth without a proportionate growth in management resources may lead to a rapid loss of control.

Reporting

An ill-defined reporting structure and definition of responsibilities can lead a lack of corporate focus and may culminate in managerial conflict.

Distractions

Companies often fail when excessive management and other resources are devoted to non-core activities or to loss-making activities.

How to tell when a business is in trouble

Creditors and advisers can quickly diagnose the health of a business – if they know what to look for.

Warning signs

Common sense is the most valuable quality in detecting business failure.

The process primarily involves regular access to meaningful, timely information. This enables analysis of past, current and future performance and an assessment of the company's ability to forecast and explain variances between actual and budget, plus run-on effects.

On-site visit

Lenders and advisers should take the time to visit the borrower's (or client's) premises and meet the team.

They should look for structural management defects, poor financial information systems and a failure to respond to the industry environment (including government policy, industrial unrest, mergers, price competition, changes in demand etc).

They should also note staff comments, particularly where there is a high staff turnover.

Financial signs

Financial signs of business failure include:

- Under capitalisation and high gearing;
- Poor management of assets and liabilities – sale of plant, offers of part-payment of bills, overstatement of value of debtors and stock, understatement of liabilities;
- Losses or reduced earnings; and
- Poor liquidity or cash flow management – post dated cheques, unkempt promises, poor receivables collections and management, poor payables management.

A company's prospects of failing increase if it overtrades or launches a big project beyond the company's resources, or if it allows gearing to increase beyond comfortable limits and resources.

The process of decline accelerates as cash flow deteriorates. Without cash flow, failure is certain.

Some companies, at this stage, can be severely damaged by constraints on their ability to respond to change. Then, as a company slides into insolvency and financial ratios deteriorate, it may begin to employ cosmetic accounting.

Cosmetic accounting may involve transactions between related companies; capitalisation of interest and charges; changing accounting methods; revaluation of intangibles; overstatement of debtors and stock; post balance date events; premature accounting for sales; and different accounting periods within a group of companies

Non-financial signs

Non-financial symptoms of business failure appear as a company starts to enter its dramatic last few months before collapse.

They include behavioural changes among directors, sudden changes in strategy, delays and excuses, fabrication of the truth, and the loss of principal suppliers or clients.