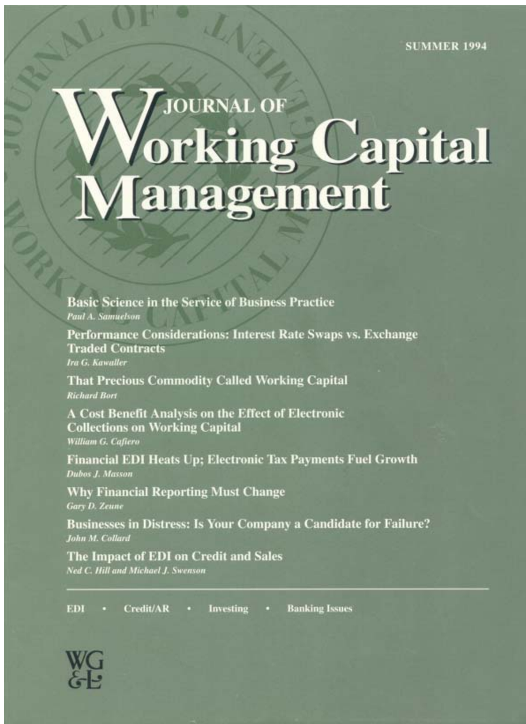

Businesses in Distress: Is Your Company a Candidate for Failure?

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This article is the first of a two-part series that seeks to help corporate financial managers to identify problems that may grow to threaten the very survival of their business. This part describes the early warning signs and the possible implications. Part 2, in the Winter issue, will describe a business turnaround process and how to deal with the critical issues of that process.

Part 1 of 2

Understanding why businesses fail can help the corporate financial manager recognize the ominous signs that portend trouble. Roughly 80 percent or more of business failures are traceable to internal or management controlled factors. These factors are many, including:

- ***Autocratic management*** evidenced by a reluctance to delegate authority or train new management. When managers continue to do the work that should be done by others, management becomes over extended. The problem is further compounded because often this situation produces unclear lines of authority.
- ***Ineffective communications*** between management and employees. Unnecessary or ineffective meetings, management information or interdepartmental coordination can destroy a business as it grows.
- ***Neglect of human resources*** indicated by excessive turnover rates. Turnover is a sign of serious problems; ignoring these problems results in low morale, lost wages, lack of production, and lost business.
- ***Inefficient compensation and incentive programs*** yielding unsatisfactory results. While it seems logical to reward for successful job performance, many companies unwittingly reward employee performance far different from that outlined in the job description.
- ***Company goals not achieved.*** Failure to meet goals often means goals are not clearly understood. The problems can also indicate failure to get all stakeholders to "buy in."
- ***Deteriorating business*** from established clients and new prospects. When long-term clients reduce their amount of business, this usually means the company is not meeting the customers' needs. Failure to secure new business is often a sign that strategies are outdated, and management is out of touch with the marketplace.
- ***Inadequate analysis of markets and strategies.*** Disciplined analysis is one business strategy that is often overlooked. A company whose products or services are developed before market needs are reviewed often must create their own demand to survive. This will cost a business several times more than a product or service that meets an existing demand.
- ***Lack of timely financial/ information.*** Financial and management reports that are late or contain irrelevant or inaccurate information hamper management's ability to understand its true financial performance. many businesses are managed on profit and loss performance rather than cash flow.
- ***History of failed expansion plans.*** Expansion plan setbacks not only drain a lousiness' cash, time, and morale, but also create reluctance to embark on future growth and expansion plans. Expansion efforts often fail due to lack of cash, management expertise, or thorough market analysis.
- ***Uncontrolled or mismanaged growth.*** Many businesses focus solely on one piece of the business (e.g., sales growth, operations, or supporting infrastructure) and neglect the other aspects. As a result, the business functions do not support each other, which severely impedes the firm's ability to support growth.

On the other hand, management may blame the business' misfortunes on external factors that management believes to be beyond its control, such as:

- General economy;
- Unfavorable legislation;
- Interest rate fluctuations;
- Labor unrest;
- Labor cost increases;
- Competition;
- Litigation;
- Market decline; and
- Raw material cost increases.

Instead, management must be realistic, be held accountable, and correct the situation. This is not to say that management is inept; but to survive, management must maintain a constant vigil over its operations and its objectives. Capitalism breeds both success and failure. Darwin is alive and well in the marketplace: only the fittest survive.

COMPANIES SUSCEPTIBLE to TROUBLE

All businesses are as vulnerable to trouble as they are to the lure of success. We live in a world of wildly changing technologies. Even with these changes, a properly managed business will continue to prosper. However, some industries are more susceptible to trouble than others.

The fortunes of companies in ***cyclical industries*** often depend upon uncontrollable external forces such as commodity prices or weather conditions. Those most likely to withstand the effects of these forces are those that either diversify without losing sight of their objectives, or that are able to control fixed costs in the face of unstable conditions. The ability to adapt is critical.

Companies in newly ***deregulated industries*** must learn to survive in a competitive environment without the legal protections they previously enjoyed. Deregulation generally is accompanied by an anticipated shake out of the weakest businesses as competitive forces take hold in the marketplace.

As the U.S. has evolved from a primarily manufacturing driven economy to increasingly ***service oriented industries***, management must recognize that its most irreplaceable assets walk out the door every night. Managing human resources is more important than ever.

Companies lacking a proprietary product, or "me too" companies, are subject to attack from every direction. These companies, such as retail businesses and non-licensed service sector businesses, generally face low entry barriers with respect to both capital and expertise.

Many entrepreneurial companies and start ups are limited to a single product or a passing fad. To ultimately succeed, ***single product and single customer companies*** usually must develop new products or diversify to protect themselves from powerful competitors, customers. and changing currents. Few are able to maintain their start up success as they struggle to compete. Reaching maturity takes years during which a company is vulnerable.

Rapidly growing companies often are driven bv entrepreneurial zeal and by an overwhelming emphasis on sales growth, while inadequate attention is given to the effects of growth on the balance sheet. These companies suddenly find themselves in a situation where the balance sheet simply cannot support the growth.

Highly leveraged businesses have so many factors that must converge to be successful that they are often most susceptible to the external uncontrollable causes of business failure. such as interest rate fluctuations or an increase in raw material costs.

Closely-held and family-owned businesses, bv their nature, select leadership based not on managerial ability but by virtue of family or close personal relationships with the shareholders. More than in other businesses, owner/managers link their personal psyche to that of their business. Owner/managers often believe that they are irreplaceable or are afraid to admit it. They want to maintain control ad infinitum, "'ailing to either develop a management team or a plan for transition of management. Owner/managers are reluctant to acknowledge the early warning signs of failure and are also apt to ignore them.

Perhaps ***declining industries*** face the most challenging task of all in preventing failure. Declining industries are those in which total industry wide unit shipments are declining. Maintaining market share involves taking business from competitors. Management that refuses to admit that the industry is declining or bets its future on industry recovery, is the most prone to failure.

Entrepreneuria1 hazards. Approximately 70 percent of entrepreneurs and start-ups fail within two years. Entrepreneurs do not necessarily have managerial abilities. They have visions of what the future will look like before the rest of us know to invent the better mouse trap. Their modus operandi is to capitalize on their head start as a way to convert their vision to a profitable reality. The same skills that keep an entrepreneur focused on an idea, regardless of obstacles, can make him oblivious to the competition on his heels or to new changes in the market. Ultimately the market catches up, forcing them to compete in a mature industry rather than in an emerging industry. As entrepreneurs survive the transition to professional management and new technologies gain a stronghold on the economy. emerging industries are born.

HOW TO DIAGNOSE TROUBLE

What are the warning indicators of a business heading toward trouble? Trouble can come from a variety of circumstances. The obvious signals arc rarely the root cause of the problem. Losing money; for example, is not the problem; it is the result of other problems.

The list of warning indicators below is by no means all inclusive, but it may provide both a barometer and some insight as to why the company is facing difficulty: They include

- Decrease in profit margins:
- Decrease in sales;
- Continued failure to meet bank loan covenants: and
- Decrease in available cash.

Indicators connected with a company's operational performance include:

- Lack of both short and long term planning and forecasting;
- Quality control problems, such as increased returned goods and customer complaints:
- Late or slow delivery;
- Increase in fixed costs relative to revenues;
- Management and employee turnover;
- General employee dissatisfaction and performance;
- Employee layoffs;
- Declining revenues per employee;
- Trade credit difficulties and restrictions:
- Failure to take purchase and other cash discounts;
- Delay in returning telephone calls;
- Delay in submitting financial statements to banks, lenders, and suppliers;
- Board of Directors resignations;
- Board of Directors failure to diligently exercise its oversight function;
- Return of the "retired" founder to a visible management position; and
- Failure to adapt to new technologies.

Symptoms associated with a business' poor utilization of assets include:

- Worsening cash position—reduced working capital;
- Decrease in quick asset ratio;
- Increase in the debt to equity ratio;
- Dwindling capital base;
- Declining asset turnover rate;
- Declining accounts receivable turnover rate;
- Deteriorating account receivable aging;
- Declining inventory turnover rate;
- Deteriorating account payable aging;
- Creeping loan balances;
- Reduced R&D expenditures;
- Changing accounting principles;
- Financing the purchase of fixed assets out of working capital;
- Overpaying for assets or business units; and
- Acquisitions of, or expansion into, non core related businesses or into businesses which cut into or compete with the core business.

These are merely indicators and not the problems. They are simply the evidence that a problem exists; it is the problem, rather than the symptom, that must be identified and remedied.

Several formulas exist to predict failure. One widely known formula is the Z-Score, developed by Professor Edward Altman of New York University. By. weighing various financial ratios, the Z-Score attempts to predict whether a manufacturing company is a bankruptcy candidate. The formula:

$$Z = 1.2A + 1.4B + 3.3C + 0.6D + 1.0E$$

Where:

A = Working Capital / Total Assets

B = Retained Earnings / Total Assets

C = Earning Before Interest and Taxes / Total Assets

D = Market Value of Equity (*) / Book Value of Total Debt

E = Sales / Total Assets

(*)When the company is not publicly traded, book value of equity should be substituted for market value.

The resulting scores are interpreted to indicate the following:

Less than 1.8 — The company has a high probability for bankruptcy within the next two years.

Between 1.8 & 3.0 — The gray zone where the trend is the really the most important criteria.

Greater than 3.0 — The company has a low probability for bankruptcy.

A second statistical method developed by Jarrod Wilcox, a former assistant professor at MIT's Sloan School of Business, is known as the Gambler's Ruin Prediction of Bankruptcy. This formula, designed to predict possible bankruptcy for both manufacturing and retail companies up to five years in advance, is as follows:

Liquidation Value = Assets - Liabilities

Where:

Assets = 100% of cash and marketable securities plus 70% of accounts receivable, inventory, and prepaid expenses plus 50% of remaining assets.

Change in Liquidation Value from previous year = Earnings before special items minus 100% of dividends minus 50% of the year's capital expenditures and depreciation minus 30% of increase in inventories and accounts receivable since the prior year.

If these computations indicate negative amounts, the company is considered a candidate for bankruptcy.

MAKING a COMMITMENT to CHANGE

Management must attempt to understand its business needs, and it should be willing to face some highly difficult issues. With statistics generally pointing to mismanagement at the root of most crises, management should adopt a mindset that it wants to participate in the recovery, that it may need the help of a turnaround specialist to be the catalyst to the recovery, and that it wants to learn as much as possible so that it can better manage the business on the other side of the turnaround engagement. Therefore, management should ask itself some hard questions:

- Can a turnaround be realistically achieved?
- Is management aware that a true turnaround can take years to accomplish?
- What can be reasonable and realistically expected from the turnaround specialist?
- Have business issues been isolated from personal issues? Or, is the primary goal of hiring the turnaround specialist to protect the owner from personal guarantees and preserve personally owned assets?
- Is management willing to admit that the business' problems are, in all likelihood, the result of mismanagement?
- Is management willing to become, if necessary, the student rather than the teacher, or the follower rather than the leader?
- If asked to give up the controls of the business, is management willing to do so?
- Is management willing to face its own shortcomings and to face facts that may reflect on its ability?
- Since the turnaround specialist is often a temporary fix, is management willing to change?
- Can management learn to function in a highly controlled environment, subject to being monitored bv outsiders?
- Is management willing to accept the business' failure since some are simply unavoidable and not salvageable?
- Is management willing to agree to a turnaround specialist's engagement if the only realistic expectation is to maximize liquidation value?
- Is management willing to sell control and become both a minority shareholder and an employee of a new board of directors, if necessary, to attract the capital needed to preserve the company?
- Is management, particularly in the case of a smaller business, willing to face the stigma of bankruptcy?

THE RECOVERY PROCESS

The process of recovery, when using a turnaround specialist, involves several stages.

Fact finding. The turnaround specialist must learn as much as possible as quickly as possible about the present circumstances of the company.

Analysis of the facts. The turnaround specialist should prepare an assessment of the current state of the company.

Preparation of a business plan outlining and suggesting possible courses of action. The turnaround specialist will seek the input of the company's management to determine which of several alternative courses of action should be undertaken.

Implementation of the business plan. Once the course of action has been chosen, the turnaround specialist should be involved in implementing the plan, either as an interim manager or as a consultant to management. This is the time a specialist begins to build the team of players both inside the company and from outside resources.

Monitor the business plan. The turnaround specialist should keep vigil over the plan, analyzing variances to determine their causes, and the validity of the underlying assumptions.

Stabilization and transition. Assuming that liquidation is not the cornerstone of the business plan, the turnaround specialist should remain involved in the engagement until the business has achieved stabilization and to assist the business in a transition of management if necessary.

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