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02 HOW TO AVOID BUSINESS FAILURE

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There are three main reasons why businesses fail, according to accountants and business advisors, Cooney Carey. Most failures are a result of Financial, Trading or Management issues, or a combination of all three. If these problems are recognised and treated early, then failure is not inevitable, says ***Tony Carey****, Managing Partner.*

Cooney Carey has significant experience in corporate recovery and business structuring. In the second of three linked articles examining these issues, Tony draws on this experience. He also includes some sound advice from senior financial and banking experts, as well as the comments of Irish business people who have not only survived the current recession but have emerged with stronger businesses by following this advice.

The second article examines the most common trading causes of business failure.

THE MOST COMMON TRADING CAUSES OF BUSINESS FAILURE

1. Overtrading
2. Costing and Pricing
3. Market Changes
4. Commodity Price Movements
5. Industry Failure
6. Small Customer Base
7. Inability to Sell and Market

01. OVERTRADING

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

Overtrading occurs when companies pursue inappropriate 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 stock, debtors and capital expenditure. 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 cash flow problems.

Most managers who 'grew up' in management in the last 10 years would not recognise that slow & steady growth is a better insurer of business survival than rapid expansion!
Seamus Carney Ulster Bank Senior Manager

02. 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 be tempted to chase turnover. There are many examples of businesses that have, and indeed will use such an exercise as an excuse not to cut costs. These businesses have dropped 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, and just stay in business. Then, 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.

Protecting your margin is key. Consideration must be given to what discounts you can obtain from your suppliers. Excessive cost cutting will have many ramifications. For example, does a cost cutting decision have a detrimental effect on staff morale, and in turn, on productivity? Should you cut discretionary spend such as advertising or is the better decision to increase it? Consider the impact long term as well as in the short term.

In relation to costing and pricing, "Profit is sanity, turnover is vanity". Every sale or deal should contribute to the bottom line. If you're pricing a loss-leader, how sure are you it will deliver a profit generating sale at a later time?
David Hammond AIB Commercial Banking Head of Commercial Centre - Dublin South

03. 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 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 may be 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. 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.

Knowing your market is vital. Expanding into related segments or geographies where you lack expertise can be a costly educational process. Stick with sectors and segments you understand and if you expand your business into new geographies make sure you have done your market analysis and second management to the new entity.
Barry O'Connor
Director at MERC Partners

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

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

05. 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 becoming over exposed to one sector. Obvious examples in the current market are the property and tourism sectors.

06. SMALL CUSTOMER AND PRODUCT BASE

Beware of over reliance on a small number of customers or products. 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 ensures 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

Business should be careful of over reliance on a single supplier – or a single customer. A business can also fail due to issues surrounding a principal supplier if supplies are disrupted (through a dispute or insolvency for example) with no immediate alternative available.
Seamus Carney Ulster Bank Senior Manager

07. INABILITY TO SELL AND MARKET

During boom times a business can survive without adequate selling skills. When demand outstrips supply poor businesses can flourish. However that is not the case at the moment. Good selling skills and sales management procedures are a necessity.

Management of the sales process involves 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.

Can the business owner describe the "USP" of his product or service in one sentence? If you're explaining, you're losing.
David Hammond AIB Commercial Banking Head of Commercial Centre - Dublin South

How does your business differentiate itself from your competitors? What is your unique selling proposition? Do you have a strength or a USP that is different from your competitors?
Denis Bergin Head of Business Development- Bank of Ireland Business Banking

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