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01 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 these. If 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 first 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 first article examines the most common financial causes of business failure.

THE MOST COMMON FINANCIAL CAUSES OF BUSINESS FAILURE

1. Lack of Cash and Cash Management
2. Lack of Equity
3. Inappropriate Financial Management
4. Inappropriate Capital Expenditure
5. Lack of Financial Control and Information
6. Lack of Cost Control

01. 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 reduce overdrafts and insurers are withdrawing debtor cover. 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.

Tell creditors when they will be paid. People are more patient and understanding when they know. Truth builds confidence.

Understanding cash flows and managing customers' and suppliers' expectations is absolutely vital.

Many businesses are not making the most of their largest assets. Invoice discounting can release up to 85% of the value of debtors, while leasing can boost working capital by realising the value of already owned assets such as plant, equipment or machinery.
Paul Stephens, Close Brothers Commercial Finance, Head of Sales, Ireland

02. LACK OF EQUITY

Very many new businesses are under capitalised and rely on debt or supplier 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, thus ensuring continuity of funding. Having a secure source of finance in place is critical to facilitate the business in taking the reasonable risks necessary in developing or continuing to trade.

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 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.

From the Bank's perspective "cash is king"! It impinges on every aspect of the business including sales, margins, overheads, debtor & creditor days, stock days, and discretionary capital expenditures.
Seamus Carney Ulster Bank Senior Manager

03. INAPPROPRIATE FINANCIAL MANAGEMENT

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

In the past the banks gave "interest only" loans to address this issue, in our experience such loans are no longer available.

Insufficient gearing may also be deemed to be inappropriate financial management in certain circumstances. Whereas a highly aggressive financial policy can lead to the rapid development of a 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 is an example of inappropriate financial management, and is an indicator of an inefficient or non-existent risk hedging strategy.

Many managements over gear the business in order to make better returns. They use debt to fund acquisitions and then struggle badly when the heat is turned on. There are many examples of businesses now in this position with a high level of debt. They now have an ongoing focus on cost reduction to ensure survival while more financially flexible competitors take market share.
Padraic Kiernan ACC
Bank General Manager
- Credit Special Asset
Management Bank

04. 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 can 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 premise's purchase would have been extracted from cash flow / working capital.

In the current market loan repayments are likely to be higher than any rent payable. The double effect of reduced working capital availability and higher fixed costs is a major cause of business failure.

It is important to demonstrate to your bank that whilst a property loan might be in difficulty, the underlying trade may be healthy.

05. 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, cash flow forecasting systems, costing systems and budgetary control systems might not exist. Similarly, key performance indicators (KPIs), such as 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 and inappropriate – an audit is produced at year end and is usually available six months after that year end. The statutory layout of audited accounts can also 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 should establish what the key variable drivers are (KPIs) and report quickly, at least monthly, on the same with a Flash Report (Key Performance Indicators report, produced within 5 days of months end).

Sales, Gross Profit and Wages are KPI's that vary, whereas Rent, Rates and Insurance are relatively fixed in nature and therefore do not need to be measured as often, an estimate on the Flash Report can suffice. The Flash Report should be supplemented quarterly with a full set of accounts and analysis. If decisions are critical, however, then Flash Reports will not be adequate; they are merely an indicator.

Banks are far more forensic today and require quarterly management accounts for most medium sized business.
Denis Bergin Head of Business Development- Bank of Ireland Business Banking

On the information side, any reasonably sized trading business should produce monthly management accounts, rolling cash flows, and reviews against budget, and proactively submit to their Lenders with explanations on any variances positive or negative. Poor controls on debtors, in particular, is one of the most common causes, where collection can be haphazard, management information on debtors can be poor and no one person in the business is on top of the situation.
David Hammond AIB Commercial Banking Head of Commercial Centre - Dublin South

06. LACK OF COST CONTROL

All costs, whatever the state of the economy, should be closely monitored and controlled. Cost cutting should be strategically viewed; for example, be careful of cutting costs in areas that are critical such as 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 cash flow and have less borrowing power.

With fewer 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 limit a company's ability to compete in terms of price.

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