International Journal of Multidisciplinary Approach and Studies

ISSN NO:: 2348 – 537X

# Human Inadequacies in Corporate Failures: A Case Study

**Dr. Abha Mohan * & Dr. Vinay Mohan****

**Associate Professor, Department of Humanities and Commerce, JECRC University, Jaipur.*

***A techno-commercial management professional & practising consultant, is the promoter of Financial & Industrial Development Corporation (FIDCO).*

**ABSTRACT:**

*The present study differs from general Corporate Failure studies surmising that organizations fail, due their inability to repay their debt and interest obligations, i.e. lack of sufficient cash flows from operating activities. Empirical studies are based on Balance Sheet data which is historical in nature, reflecting the position that has already occurred. These reflect the "effect", not the "cause". In fact, managerial actions can precipitate/ obviate corporate failure. A corporate can falter, or ultimately fail, due to Internal and/or External reasons. Internal causes arise due to disorder in the corporate's various areas like production, planning, marketing, finance and personnel. These can be controlled provided the corporate management is efficient and effective. This paper seeks to examine the usefulness of correcting human inadequacies in arresting corporate failures.*

**BACKGROUND:**

"It was the best of times, it was the worst of times ..." These prophetic words, written against the backdrop of the French Revolution in the 18$^{th}$ century, could easily be construed as the effects of the Industrial Revolution, sweeping over Europe almost a century later. In fact, posterity would record the present milieu of economic growth and corporate failures witnessed globally, in an almost similar fashion.

Industrial and economic growth in recent times has indeed been phenomenal, witnessing technological development, broad-basing of mobilisation/ deployment of resources and removal of regional imbalances through globalisation. And still, the "Wealth of Nations" predicted almost two centuries back (1776) by Adam Smith, has only metamorphosed in

Gunnar Myrdal's conceptualisation of the "Poverty of Nations"( Asian Drama: An inquiry into the Poverty of Nations, 1968). It is a paradox brought about in no mean measure by Human Inadequacies leading to Corporate Failures.

Corporate failure is the process of a company closing due to their inability to make a profit to sustain their own costs. When the economy is bad there are many examples of corporate failure that can be seen and felt. Corporate failures are an integral part of economic growth. Social progress is achieved by constant improvements in the technical forces of production, and the new ongoing discoveries of processes and products. Inevitably, outdated technologies and products must perish. This elucidates the hard truth that technological/ corporate failures are a concomitant of economic growth. It is in this context that a thorough understanding of the essence and consequence of corporate failure gains significance so that its impact can be contained.

One of the most significant threats for many businesses today, despite their size and the nature of their operations, is insolvency. Extant evidence shows that in the past two decades business failures have occurred at higher rates than at any time since the early 1930s. It is also interesting to note that during the 1980s certain sectors of the UK economy, such as small industrial businesses in depressed areas, experienced failure rates as high as 50% over a five-year period. The factors that lead businesses to failure vary. Many economists attribute the phenomenon to high interest rates, recession-squeezed profits and heavy debt burdens. Furthermore, industry-specific characteristics, such as government regulation and the nature of operations, can contribute to a firm's financial distress. Studies of patterns of business failure in the UK, US, Canada and Australia found that small, private and newly founded companies with ineffective control procedures and poor cash flow planning are more vulnerable to financial distress than large well-established public firms. The economic cost of business failures is significant; evidence shows that the market value of the distressed firms declines substantially prior to their ultimate collapse. Hence, the suppliers of capital, investors and creditors, as well as management and employees, are severely affected by business failures. The auditors also face the threat of a potential lawsuit if they fail to provide early warning signals about failing firms through the issuance of qualified audit opinions. Indeed, the need for reliable empirical models that predict corporate failure promptly and accurately is imperative to enable the parties concerned to take either preventive or corrective action. Although a substantial volume of failure prediction studies has been published worldwide since Altman's pioneering work, research interest has declined in the past few years. The majority of current failure prediction studies employ Multiple Discriminant Analysis (MDA). However, despite the popularity of the MDA technique in constructing failure classification models, questions were raised regarding the restrictive statistical requirements imposed by such models. Also, the researchers did not examine the usefulness of operating cash flow information in explaining financial distress, despite the increased interest in cash flow reportings. Thus, the main objectives of this study were to develop reliable failure prediction models for UK public industrial firms using a more recent dataset, and to explore the incremental information content of operating cash flows in explaining and predicting financial collapse. Logit analysis and neural networks (NNs) are used to develop alternative prediction models and several cash flow-based financial ratios are tested in order to examine whether they have the potential to provide warning signals over more conventional, accrual-based variables.

The present study differs from prior failure studies in the following respects. The majority of researchers who have conducted failure prediction studies admit that one of the major reasons that organizations fail is their inability to repay their debt and interest obligations, i.e. lack of sufficient cash flows from operating activities. Empirical studies are based on Balance Sheet data which is historical in nature, reflecting the position that has already occurred. The studies thus reflect the "effect", not the "cause". Their nature is thus more by way of post-mortem than a diagnosis.

While major cases of corporate failures stand out in public memory, with perceptible reasons attributed for failure tagged, such as, Pan Am (1991) - global competition, Bethlehem Steel (2001) – non adjustment to service based economy, Enron (2001) – misfeasance /greed, Polaroid (2005) - technology lag, Kingfisher Airlines (2010) – high overheads and profligacy, fact remains that the underlying reason was human failure. This raises the managerial role and the human angle.

**CAUSES OF CORPORATE STRESS:**

Coming to the Indian context, question arises that can managerial actions precipitate/ obviate corporate failure? As the business climate deteriorates or the guidance of the firm falls into the hands of people with less energy and less creative genius, the firm starts sinking deep into troubled water and there comes a time when continuing the money losing operation becomes too painful to bear and failure becomes imminent. Managers may buy some time to save the sinking ship by liquidating assets to finance their excessive continuation, but as the liquidity runs out the inevitable reckoning with failure strikes hard and equity holders are faced with the ultimate decision of being acquired or going bankrupt. Unfortunately, this scenario is all too common in the modern corporate landscape. Yet, our understanding of the causes of failure is very limited even though this issue bears tremendous importance for investors, managers, and policy-makers alike.

The problems being faced by corporates get reflected in the form of certain symptoms manifested as early warning signals; not identifying such signals are construed as human failure in monitoring / decision-making. In order to handle the problem of corporate failures it is essential to identify its causes. A corporate can falter, or ultimately fail, due to a number of reasons. These reasons can be classified into two main categories: Internal and External. The internal causes arise due to disorder in the corporate's various areas like production, planning, marketing, finance and personnel. These can be controlled provided the corporate management is efficient and effective. The external causes are due to changes in the environment which can be influenced by social, political, international and other factors beyond the control of any corporate’s management.

The main causes under these categories can be from the list below:

**A Internal Causes:**

1. Planning:

a) Technical Feasibility:

- Inadequate technical know-how.
- Locational disadvantage.
- Out dated production process.

b) Economic Viability:

- High cost of inputs.
- High Break-even point.
- Uneconomic size of project.
- Under estimation of financial requirements.
- Unduly large investment in fixed assets.
- Over estimation of demand.

2. Implementation:

Cost overruns resulting from

- Delays In getting licences / sanctions, etc.
- Inadequate mobilization of finance.

3. Production

a) Production:

- Inappropriate product mix.
- Poor quality control.
- High cost of production.

- Poor inventory management
- Inadequate maintenance and replacement.
- Lack of timely and adequate modernization etc.
- High wastage.
- Poor capacity utilization.

b) Labour Management:

- Excessively high wage structure.
- Inefficient handling of labour problems.
- Excessive manpower.
- Poor labour productivity.
- Poor labour relations.
- Lack of trained /skilled labour or technically competent personnel.

c). Marketing management:

- Dependence on single/ limited number of customers/ products.
- Poor sales realization.
- Defective pricing policy.
- Booking large orders at fixed prices in an inflationary market.
- Weak market organization.
- Lack of market feedback and market research.

- Lack of knowledge of marketing techniques.
- Unscrupulous sales/ purchase practices.

d). Financial Management:

- Poor resources management and financial planning.
- Faulty costing.
- Liberal dividend policy.
- General financial indiscipline and diversion of funds.
- Deficiency of funds.
- Over trading.
- Unfavourable gearing or keeping adverse debt equity ratio.
- Inadequate working capital.
- Absence of cost consciousness.
- Lack of effective collection machinery.

e) Administrative Management:

- Over centralization.
- Lack of professionalism
- Lack of feedback / inadequate Management Information System
- Lack of controls.
- Inadequate / Excessive expenditure on R & D.

- Divided loyalties / Biased Management with differing loyalties.
- Dissension within the management.
- Incompetent management.
- Dishonest management.

**B. External Causes:**

a) Infrastructure Bottlenecks:

- Chronic power shortage.
- Transport bottlenecks.
- Non availability of basic raw material /other natural resources.

b) Financial Bottlenecks:

- Non availability of additional finance in time due to squeeze in economy.

c) Govt. Controls and Policies:

- Unfavourable changes in Govt. price controls.
- Unfavourable changes in fiscal duties.
- Procedural delays on part of controlling and regulating authorities.

d) Market Constraints:

- Recession in the market.
- Rapid technological changes resulting in quick product obsolescence.
- Market saturation followed by demand recession.

e) Extraneous Factors:

- Natural calamities.
- Political situations.
- Multiplicity of labour unions.
- Strikes and other similar events.

The above list is not exhaustive, but covers most of the main factors responsible for corporate failures. And most of these symptoms/ causes are the outcome of human inadequacies. Failures may be caused by several of these factors acting at the same time or at various point of time. While some of these factors are the true causal factor, there may be others, only aggravators. It is very important as a Manager to identify the "cause effect" relationship and attach the causes on priority. Usually the problems afflicting the corporate are recognized by their effects on the financial position of the company.

For Example, let us consider a hypothetical case, ' Save Me Ltd.' whose top management did not handle industrial relations well. This top management's inability to handle industrial relations well resulted in low employee morale. Low morale led to low productivity and high cost of production. This in turn resulted in declining profits and finally losses. At some point of time this would affect the availability of funds for the operations of the company which would finally come to a grinding halt.

The terminal cause is the lack of funds but the true cause is the management's poor handling of industrial relations. Often most of the analysis would stop after identifying the terminal cause like lack of funds or an intermediate cause like low productivity of workers, but seldom is the ultimate cause traced down. Until this is traced and attended to, the problem remains unsolved. In this case, if the management's inability to handle industrial relations is not diagnosed and well addressed in time, failure is to occur for sure.

**CASE STUDY**:

- ABC was established in 1964 as a fully owned Central Public Sector Enterprise (CPSE) to cater Control & Instrumentation (C&I) needs of Core Sector Industry viz. Power, Steel, Refinery etc. The company has its Registered Office & Headquarters at Kota, Rajasthan and manufacturing plants at Kota for Digital Control System, Telecom Products, Railway Signalling, Defence etc. and at Palakkad, Kerala for Control Valves/ Actuators. ABC was a pioneer Indian blue-chip company capable of integrating the systems with various state of the art equipments manufactured by different industrially advanced countries like West Germany, Japan and USA and was operating profitably up to 1989-90. ABC started incurring losses from 1991-92.

**Reasons for Losses:**

i) Entry of new competitors with low investments and on going state of the art technology backup

ii) Rapid rate of product obsolescence on account of one time technology tie-ups.

iii) Inability to close down slow or non moving obsolete products, which would result in man power reduction.

iv) Surplus man power

v) Mounting arrears of sales realizations, specially from State Electricity Boards,

vi) Resultant increase in Working Capital requirements.

vii) Increase in inventory on account of minimum order quantity insisted upon by foreign component supplier / collaborators.

viii) Weak management and organizational structure

ix) Non availability of additional funds on time from promoters(GOI) for meeting requirements / cash losses.

- With the advent of liberalization policy initiated by GOI, business areas covered by ABC (C&I Telecom etc.) became highly competitive with the entry of well known established multinational giants. As on date there are about hundred competitors for C&I in organized and unorganized sectors. However, key players are 8 for C&I and 9 for UPS. Despite tough competition from established competitors with latest technology tie-ups, ABC still continues to hold single largest market share of 26% in C&I segment.
- ABC's case was referred to BIFR in Oct.1993 after its net worth became negative. A rehabilitation scheme with cut off date as 31.12.1997 was sanctioned by BIFR in March,1999.
- Apart from financial restructuring and manpower rationalization (which were successfully accomplished - right sizing of manpower from the level 3023 as on 1st April 1999 to 1677 in 2007. ), the revival scheme had envisaged business restructuring of the company by way of i) subsidiarization of its UPS unit, Jaipur and joint venture in two units i.e. ii) Control Valves Unit, Palakkad (ICVL) and iii) Distributed Digital Control System Unit [DDC], Kota. Business restructuring could not take off due to labour and legal interventions and it was subsequently established that disinvestment of ICVL was not in accordance with the Government policy. Accordingly ABC was directed to submit a revised Rehabilitation proposal (MDRS) for considering modifications in the sanctioned Revival Scheme, in Oct. 2001.
- ABC's MDRS Was finally cleared by the Cabinet Committee on Economic Affairs CCEA (2009) and sanctioned by BIFR in 2010.

**Performance of ABC during the period :** Despite constraints, ABC continued its efforts to hold-on:

*(Rs .in crores)*

| Year | Turnover | Net Profit |
|---|---|---|
| 1990 | 105 | 0.54 |

| | | |
|---|---|---|
| 1991 | 126 | (6.18) |
| 1992 | 119 | (17.78) |
| 1993 | 139 | (5.38) |
| 1994 | 114 | (17.27) |
| 1995 | 104 | (24.07) |
| 1996 | 99 | (38.56) |
| 2001 | 106 | (34.51) |
| 2002 | 107 | (30.49) |
| 2003 | 131 | (29.17) |
| 2004 | 153 | (29.02) |
| 2005 | 176 | (16.97) |
| 2006 | 220 | (24.50) |
| 2007 | 228 | (27.80) |
| 2008 | 247 | (39.49) |

- As may be observed from the case study, two efforts at revival, through concerted efforts of the highest decision making authorities in India, have failed to take-off. The first package was sanctioned at a project cost of Rs.177 crores and the second at Rs.652 crores. The second package inter alia also involved from the promoters (GOI) Write-off of GoI loan of Rs.246.10 crore and waiver of Interest of Rs.258.26 crores (as on 31.12.2008) & freezing of Interest thereon beyond 31.12.2008. The thrust was ostensibly only on financial restructuring – cleaning the balance-sheet. The position however in 2013, even after second restructuring based on 31.12.2008 figures as above, is as under:

| | | |
|---|---|---|
| Paid up share capital (incl. Appl.money) | : | Rs. 147.07 crores |
| Net worth | : | (-) Rs. 88.40 crores |
| Accumulated losses | : | (-) Rs. 220.71 crores |

- The lacks of insight into the core issues discussed above as the reasons were left unattended/ did not receive the desired focus. Neglect of the crux of the problems by the management and the promoters (GOI) of ABC highlights the impact of Human Inadequacies.

**INFERENCES:**

Stressed corporate beyond redemption need not waste further public funds. It may thus be prudent not to waste 'good money' to retrieve 'bad money'. The fact remains, though, that a greenfield project costs much more than reviving a stressed unit. Stress implies inefficient use of assets created by using scarce resources in the economy. This hinders and stalls the socio-economic objectives such as employment generation and protection, regional development, revenue generation for the Govt., creditors, financial institutions and banks.

The case study presented above illustrates human inadequacies in not anticipating competition, not tackling primary causes of stress, neglecting minor problem areas, time lag in implementing corrective strategies and committed funds not coming in time. GOI infusing more than Rs.500 crores in small trenches over the years betrays a lack of macro vision. These are pointers to human dogmas, prejudices and shortcomings.

Efficient Management thus involves commercial reorganization of ailing but economically viable corporate or facilitating the liquidation of non viable ones so that the assets so freed can be put to a much better use. Efficient Management can, therefore, be defined as reorganizing the operations of a company, that has not been doing well, at least, to such an extent that the company is able to fulfil the demands of all the creditors to their satisfaction and be able to produce, in terms of volumes, the amount it was producing earlier so that it is able to generate returns to the equity holders of the company. The other social factors like protection of employment, ancillary units etc. are implied to be taken care of when the above twin objectives of productivity and profitability are achieved. Thus, the impact of human inadequacies in corporate failures cannot be overemphasised.

**REFERENCES:**

i. Altman E., "Financial Ratios, Discriminant Analysis and the Prediction of Corporate Bankruptcy", *The Journal of Finance* (September 1968).

ii. Baldwin J. and G. Glezen, "Bankruptcy Prediction Using Quarterly Financial Statement Data", *Journal of Accounting, Auditing & Finance* (1992).

iii. Beaver W., "Financial Ratios as Predictors of Failure", *Empirical Research in Accounting, Supplement, Vol. 5, Journal of Accounting Research* (1966).

iv. Blum M., "Failing Company Discriminant Analysis", *Journal of Accounting Research* (Spring 1974).

v. Boritz J. E., "The 'Going Concern' Assumption: Accounting and Auditing Indications", 1991.

vi. Boritz J. E., D. B. Kennedy and A. Albuquerque, "Predicting Corporate Failure Using a Neural Network Approach", *Intelligent Systems in Accounting, Finance and Management* (Vol.4- 1995).

vii. Casey C. and N. Bartczak, "Using Operating Cash Flow Data to Predict Financial Distress: Some Extensions", *Journal of Accounting Research* (Spring 1985).

viii. Charitou, A. and N. Vafeas, The Association between Operating Cash Flows and Dividend Changes: An Empirical Investigation, *Journal of Business Finance and Accounting*, Vol. 25, Nos. 1and 2 (1998).

ix. Coats K. P. and L. F. Fant, "Recognising Financial Distress Patterns Using a Neural Network Tool", *Financial Management* (1993).

x. Deakin E., "A Discriminant Analysis of Predictors of Business Failure", *Journal of Accounting Research* (Spring 1972).

xi. Deptt. Of Economic Affairs, Ministry of Finance, Govt. Of India, (2013) *"Economic Survey 2012-13"*, Oxford Press.

xii. Dickens Charles (1859), A Tale of Two Cities, Collins.

xiii. Gentry J. A., P. Newbold and D. Whitford, "Classifying Bankrupt Firms with Funds Flow Components", *Journal of Accounting Research* (Spring 1985).

xiv. Gilbert L., K. Menon and K. Schwartz, "Predicting Bankruptcy for Firms in Financial Distress", *Journal of Business Finance* (Spring 1990).

xv. Johnsen T. and R. W. Melicher, "Predicting Corporate Bankruptcy and Financial Distress: Information Value Added by Multinomial Logit Models", *Journal of Economics and Business* (1994).

xvi. Keasey K. and R. Watson, "Financial Distress Prediction Models: A Review Of Their Usefulness", *British Journal of Management* (July 1991).

xvii. Khandwalla, Pradip N, "*Effective Management & Turnaround of Sick Enterprises*", A Study Commissioned by the IDBI (1984).

xviii. Myrdal Gunnar, "Asian Drama: An Inquiry into the Poverty of Nations", *Corinthian Press* (1968).

xix. Smith Adam, "The Wealth of Nations", *Strahan & Cadell* (1776).

xx. Tiwari P. et all, "Report of the Committee to examine the legal and other difficulties faced by Banks and Financial Institutions in Rehabilitation of Sick Industrial Undertakings and suggest remedial measures including changes in law" (1984), Reserve Bank of India, Bombay.


**The Case Study presented is further based on Unpublished Records, Records of BIFR Proceedings, Company's Annual Reports apart from hands-on exposure of leading the subject Company by Dr Vinay Mohan during the period 2005-2008.**