A STUDY ON CORPORATE FAILURES AND EFFORTS FOR TURNAROUND

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CHAPTER 1

INTRODUCTION

FAILURE ! Just the thought of it makes everyone cringe with fear.

The Webster's Third New International Dictionary defines failure as :-

- "*omission of performance of an action or task" (lack of satisfactory performance or effect)*

_ *"the fact of being cumulatively inadequate or not matching hopes or expectation."*

With these sort of definitions, it's no wonder people shy away form being associated with the word, hence our tendency to avoid the subject.

However, no amount of avoidance can keep the reality of it away from us - corporate failures do happen and the burden of responsibility will have to be borne by someone.

There are various situations which constitutes corporate failure. **Economic failure** suggests that the company's cost exceeds its revenues. In other words, the internal rate of return on investments are less than the firm's cost of capital. **Insolvency** also is frequently used to specify serious financial problems. Another term often associated with failure is **technical insolvency** where the firm can no longer honour its financial obligations. Althought its assets may exceed its total liabilities, thereby indicating a positive net worth, the company simply does not have sufficient liquidity to pay its debts[1].

Three factors that determine the likelihood of survival of a firm are **leverage, profitability and liquidity**. In times of low profitability and high leverage, there is still time to correct the situation. The firm is still able to operate as it has reserves with which to keep it going and cover its loss of profits.It has also borrowed on long term basis therefore able to put off repayment and consequently, the effect on its solvency. The effects of low liquidity on the other hand, is much more immediate and there is less time to rectify the situation.

The relationship between these three elements has often been referred to as the "**Bermuda Triangle**" implying that once a company enters the high risk area, the probability of escaping without incurring damages is low.

Financial distress is not an overnight phenomenan. It is the result of cumulative events leading up to financial deterioration which could inevitably mean bankruptcy.

This is where the management's role comes in ; they should be able to detect the danger signs and act upon it immediately in order to avoid any further crisis.