Why companies fail and how boards defend against it

MODULE 4 | PART A.1 | STUDENT COMPANION

Companies rarely fail for one sudden reason. The same root causes appear again and again, usually several at once, and they grow while the people at the top fail to deal with them.

1. Poor strategy
New products or markets without understanding what drives profit there

2. Ambition and power
Growth pushed faster than the business can sustain

3. Over-expansion
Acquisitions whose cost and disruption swamp the promised benefits

4. Dominant chief executive
A board that has stopped challenging

5. Failed internal controls
Complex structures where information gets stuck

6. Ineffective board
Directors too close to management to judge it

What makes them worse
Cash strain | a culture of fear or greed | pay that rewards short-term results or risk | wilful blindness: choosing not to know

Early warning signs a director should notice

Root cause	Early warning sign	A question the board can ask
Poor strategy	Growth in markets where margins are thin or unknown	What evidence shows we understand what drives profit here?
Ambition and power	Targets keep rising faster than capacity	Can our people, systems and cash support this pace?
Over-expansion	Acquisitions follow each other before the last one is bedded down	What did the last acquisition actually deliver against its plan?
Dominant chief executive	Directors rarely disagree in the minutes	When did we last change management's proposal?
Failed internal controls	Repeated audit findings, late reconciliations	Which control weaknesses are still open, and why?
Ineffective board	Long tenure, close personal ties to management	Would an outsider see this board as independent?

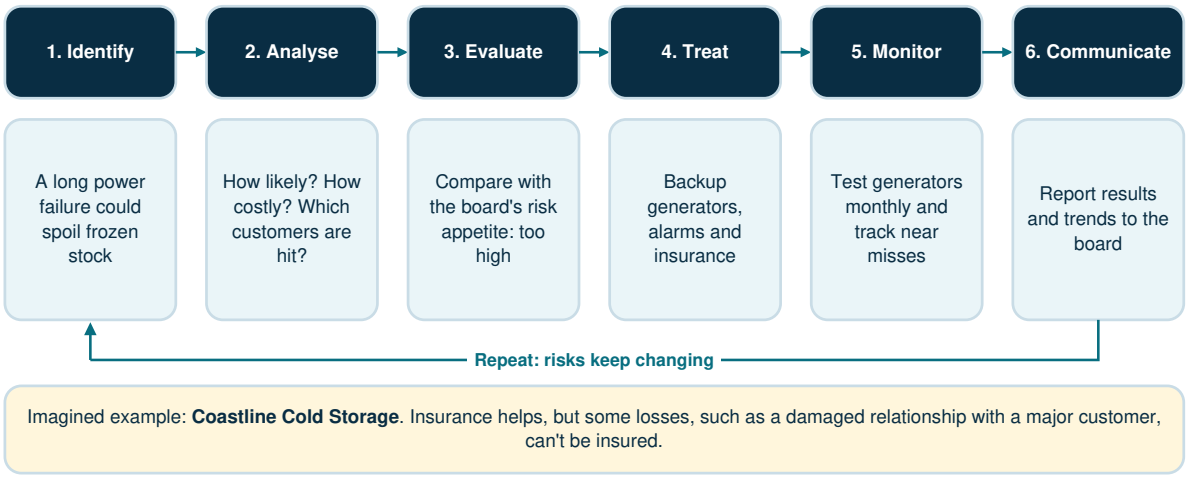
Amplifiers: cash strain (profit is not cash), a culture of fear or greed, pay that rewards short-term results or risk, and wilful blindness. Wilful blindness counts as knowledge in United States law when a person believes a fact is highly probable and deliberately avoids confirming it (Global-Tech Appliances v SEB, 2011).

The defences

MODULE 4 | PART A.1 | RISK MANAGEMENT AND INTERNAL CONTROL

Risk management: a continuous cycle

Risk management is the culture, processes and structures an organisation uses to make the most of opportunities while keeping possible losses under control. The board decides which framework suits the company.



Imagined example: **Coastline Cold Storage**. Insurance helps, but some losses, such as a damaged relationship with a major customer, can't be insured.

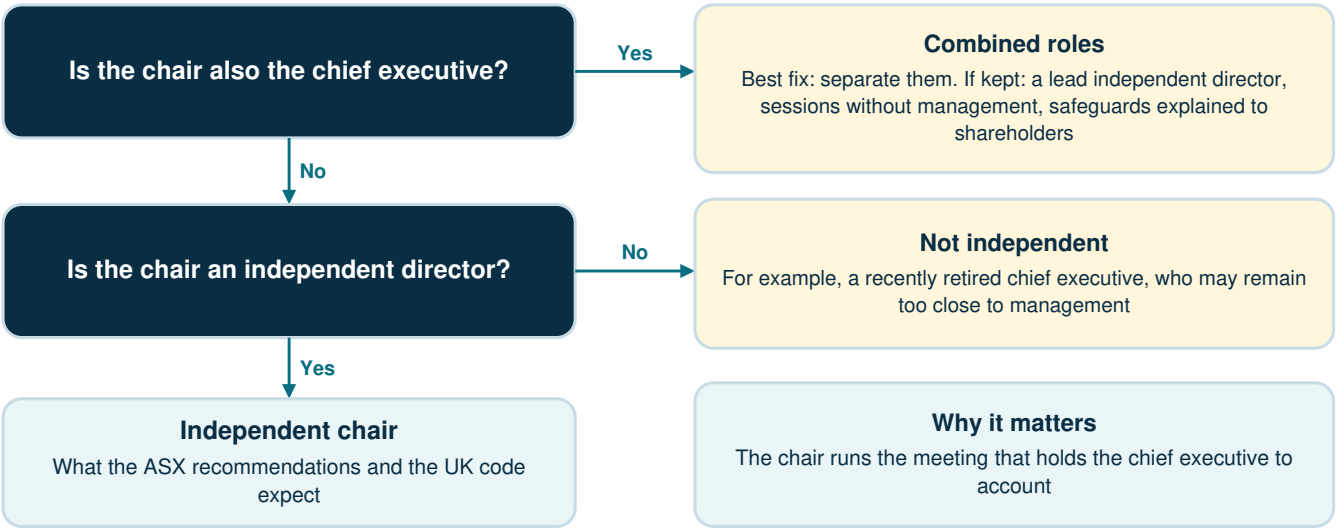
Internal control: five connected components

Component	What it means	Coastline Cold Storage example
Control environment	Tone at the top, integrity, competence, clear responsibilities	Directors model and reward honest reporting
Risk assessment process	How the company spots what could go wrong	Reviewing new cyber threats to freezer controls
Information system and communication	The right information reaches the right people	Freezer alarms go straight to the duty manager
Control activities	Everyday checks: approvals, reconciliations, separated duties	Nobody can both approve and pay a new supplier
Monitoring	Checking that the system still works	Monthly report on overdue reconciliations

An independent chair

MODULE 4 | PART A.1 | WHO LEADS THE BOARD'S CHALLENGE?

When one person is both chair and chief executive, the person running the company also runs the meeting that is supposed to hold them to account. Use this flowchart to test a board's leadership structure.



Source	What it says about the chair
ASX recommendations	A listed company's chair should be independent, and should not also be its chief executive.
UK code	The roles of chair and chief executive should not be held by the same person.
International principles	Separation is good practice but not compulsory; where the roles are combined, explain the safeguards, such as a lead independent director.
Caution	A retiring chief executive who becomes chair may remain too close to management.

Silicon Valley Bank: Federal Reserve review, 28 April 2023. Boeing: board release 11 October 2019; In re Boeing Co. Derivative Litigation (Del. Ch., September 2021); settlement of US$237.5 million (November 2021). Carillion: joint report of the UK House of Commons Work and Pensions and BEIS committees, May 2018. Coastline Cold Storage is imagined.

Practice questions

MODULE 4 | PART A.1 | TRY THESE BEFORE THE WORKED ANSWERS

Question 1 - diagnose Summit Home Builders

Imagine **Summit Home Builders Ltd**, a listed company. In three years it bought four smaller builders in two new states, all funded by borrowing. The new businesses' systems were never properly combined. The founder is both chair and chief executive, and board papers come only from him. Executive bonuses depend on revenue growth. Suppliers are being paid later and later, although reported profit keeps rising. (a) Identify at least four root causes or amplifiers. (b) Recommend three governance responses.

Question 2 - was Mei wilfully blind?

Imagine **Mei**, finance manager at **Westlake Freight Ltd**. Internal audit tells her that a sales manager may be booking fake freight orders before year-end. She thinks this is very likely true, but asks internal audit to hold its detailed report until after the annual report is signed, so that nobody can say she knew. Apply the two-part test for wilful blindness. What should she have done?

Question 3 - match the weakness to the component

Match each weakness to one of the five components of internal control: (a) the chief executive jokes that rules are for junior staff; (b) there is no process for identifying new cyber threats; (c) the same clerk sets up new suppliers and approves their payments; (d) branch managers can't get timely sales data to head office; (e) nobody checks whether monthly reconciliations are actually done.

Worked answers

MODULE 4 | PART A.1 | WORKED ANSWERS - ATTEMPT THE QUESTIONS FIRST

Question 1 - Summit Home Builders

- **Over-expansion:** four acquisitions in three years in new states, with systems never combined.
- **Dominant chief executive and ineffective board:** the founder chairs the board and controls its information.
- **Pay that rewards the wrong thing:** bonuses tied to revenue growth encourage growth at any cost.
- **Cash strain:** suppliers paid later and later even though profit is rising - profit is not cash.
- **Debt:** borrowing to fund expansion raises the stakes if the integration fails.

Possible responses: appoint an independent chair (or at least a lead independent director); require independent board papers, including cash flow and integration reports; pause acquisitions until systems are combined; rebalance bonuses towards long-term, cash and risk measures; ask the audit committee and internal audit to test controls in the acquired businesses.

Question 2 - Mei

Part one: she believes there is a high probability that fake orders are being booked. **Part two:** she takes a deliberate step, delaying the report, to avoid confirming it. Both parts are met, so under the wilful blindness approach she would be treated as knowing. She should have obtained the report, escalated it to the chief financial officer and audit committee, and made sure the revenue was investigated and corrected before the accounts were signed.

Question 3 - components

Weakness	Component
(a) Rules are for junior staff	Control environment (tone at the top)
(b) No process for new cyber threats	Risk assessment process
(c) Same clerk sets up and pays suppliers	Control activities (separation of duties)
(d) Sales data doesn't reach head office	Information system and communication
(e) Nobody checks reconciliations are done	Monitoring

Common slip: treating internal control as a set of documents. A control that exists on paper but is ignored, or that incentives reward people for bypassing, gives no protection.