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20 YEARS

The chaos chronicles

Five business situations that can rock your world—and how to keep your footing

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The five situations most likely to cause chaos are market instability (challenging shifts in everything from the wider economy to company fortunes), business transitions (think IPOs and M&A deals), funding uncertainty, changes in strategic direction, and talent shortfalls. We've lived through all of them, steering companies around the fault lines or cleaning up the mess. This report tells tales of chaos—how it happens, what results from it, how to fix it, and—most of all—how to prevent it.

True stories of the top five chaos causers

Any business faces challenges great and small, day in and day out, but some situations carry a considerable measure of risk, volatility, and disruption potential. Based on our experience helping companies shield themselves against or recover from chaotic scenarios, these five situations are most likely to cause chaos: market instability (challenging shifts in everything from the wider economy to company fortunes), business transitions (think IPOs and M&A deals), funding uncertainty, changes in strategic direction, and talent shortfalls.

By chaos, we mean hair-on-fire scrambling to prevent looming business disaster, or slow-motion disintegration into operational dysfunction, or the disarray that results when finance departments held together with duct tape and staples finally come undone, or similarly ulcer-inducing scenes. The RoseRyan crew has lived through or seen the wreckage of them all, and we have stories to share—with lessons to learn, naturally.

All the examples below are real—and they could happen to anyone. The best and brightest have found themselves caught up in chaos simply because they didn't train their attention on the risk factors. We've numbered these situations because we like numbers, but one isn't necessarily more threatening than another. If you find yourself in any of them, buckle up, because you're in for a bumpy ride.

1. Market instability: dramatic shifts in fortune can put companies on a dangerous cliff

A multinational public company misses a key technology shift in its market. The deep and lengthy recession compounds the problem. Panic and loss of confidence lead to significant turnover: the CEO, the CFO, and key finance personnel all leave the company within the space of a year. The company enters a round of layoffs and across-the-board expense cuts—a true sign of lack of direction.

Market instability comes in several varieties, and they all tend to produce chaos. Uncertainty about market strength creates fear of the unknown—companies are unsure when to act or how to move their business forward, and if that doesn't result in paralysis, it generates reactive and inconsistent decision making. In a downturn, failure to make necessary expense cuts right away often leads to multiple layoffs—the death-by-a-thousand-cuts approach that erodes morale, performance, and confidence in the management team. Market-shifting technological changes always take some companies by surprise, forcing them to scramble to catch up. And rapid growth, while a shift in the positive direction, can leave a company with inadequate infrastructure and confused, burned-out employees struggling to keep up, without clear processes or responsibilities.

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All these situations can have a major impact on a company's financial integrity. In the case above, the company made errors in its financial statements and Form 10-K, resulting in restatements and amended filings. Inaccurate accounting, missed technical issues, and poorly designed and applied controls—all leading to material weaknesses and significant deficiencies—are the natural product of staffing, process, and infrastructure breakdowns.

Cleaning up disarray like this can be a long and costly process, and can make recovery (or advancement, in the case of rapid business growth) slower than it would have been otherwise. In the case above, the company tried to rebuild its finance department with permanent resources, but, given its degraded culture and the tough competition for talent, it had problems hiring seasoned professionals. The company relied on consultants for a significant period to fix its finance infrastructure and prevent further problems in that department.

The best approach to market instability: prepare for it so that when it comes, you can keep chaos at bay. High-performing finance teams swear by these practices:

Staff strategically. During growth, don't be cheap. Hire people who can take the company to the next level. Stay lean by using consultants for specialized work and to handle short-term projects during an economic downturn.

During growth, don't be cheap.

Know when to invest. Downturns are a good time to invest in designing and implementing strategies that will propel a company ahead of competitors when the economy picks up. Companies that wait to start that project until they know the economy is rebounding risk not capturing a significant portion of the uptick. And as the pace of the business accelerates, it's hard to refine strategies or improve processes on the fly.

Implement an enterprise risk management (ERM) program. An effective ERM program helps drive informed decision making so companies can avoid chaos-causing panic. It also positions a company to better sense dangerous downward trends, market shifts, and growth opportunities.

Create an effective planning process. A good planning process will help a company see where cuts are least damaging and which cuts will hurt the company's long-term performance and survival. It should include determining the business's major triggers and developing "what if" scenarios that allow the executive team to react with sanity during a crisis.

Establish good financial controls. Strong financial controls reduce the risk of asset loss and give stakeholders confidence that the company's financial reporting is accurate.

See our *ERM: Not Just for the Big Guys* report for ideas on creating a right-sized program.

2. Funding uncertainty: when capital dries up, thirsty companies take desperate measures

A U.S. company prepares to go public in Germany in 2011. Then the eurozone crisis hits a flaming peak. Deals evaporate. Product development stalls, and the company scrambles to find alternative financing. It solves the problem, but expensively—investors hold all the cards, and they get a big chunk of capital plus access to intellectual property.

For companies making public offerings as well as those seeking private funding, market crises and disasters are a major cause of chaos: think 9/11, the housing market crash, earthquakes, and Washington's battles over budgets and debt. Basically, investment bankers don't like uncertainty and volatility, and neither do investors. They'll wait until the crisis blows over or the uncertainty goes away, thanks very much.

Companies can reduce their chances of getting caught in a crisis by planning for the worst-case scenario.

Bad industry news can also derail financing plans. Facebook's troubled IPO held up public offerings for other social networking companies and severely affected valuations in the sector; the Solyndra flameout cast a haze over energy technology investments.

Then there are the self-inflicted wounds and the slings and arrows of misfortune that leave companies gasping for funds: public companies that fail to deliver on their revenue and earnings guidance; executives or board members selling stock in the run-up to a capital raise; audits that expose material weaknesses; legal actions; failure to allow enough time to raise money, exacerbated by "soft yes" investors who fiddle with due diligence while the cash burns; the discovery of product flaws; a competitor that upends the market; major customer losses; and more.

The immediate result for public or wannabe public companies is that funds don't come in when expected or in the expected amount, or the investment comes at the cost of more dilution to existing shareholders. This typically means serious turmoil—delays in product development, layoffs, and general downsizing. Private companies may be able to get some kind of interim financing from existing investors (probably under unfavorable terms), but if only some investors are able and willing to provide more funds, a fire sale may be the only option. Even that is better than the final alternative: the company runs out of cash and it's game over.

There's usually no way to get out of these situations unscathed, and prevention often isn't possible: market crises are hard to predict, and disasters aren't predictable at all. But companies can reduce their chances of getting caught in a crisis by planning for the worst-case scenario, acting quickly when the market is favorable, and not shooting themselves in the foot. A few guidelines:

Don't be desperate. A company should never let itself get into a situation where it needs that money immediately. When planning a capital raise, set a timeline with ample cushions for delays and setbacks. Private companies should be realistic about how outside investors perceive their progress, know when they'll run out of money, understand what drives their cash burn, and model the effects of various strategies to reduce that burn, including slower product development, delayed project starts, and reduced hiring. It's crucial to be sure that reduced or deferred spending affects only the activities that have the least future value to the company.

Don't be slow or greedy. It's best not to try to time the market perfectly—the ideal time to get funds is when they are available, even if that means a smaller capital raise. In the example above, the company could have taken advantage of an earlier, better window by going through the IPO process quicker. Much time was frittered away arguing over ultimately trivial issues with the company's bankers and auditors. And many companies vastly underestimate the time it takes to prepare for an IPO, causing them to miss the window they're shooting for.

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Don't inflate expectations. The temptation to do this can be strong, especially when trying to attract investment bank interest in an IPO, but in the case of revenue guidance, it's better to provide lower numbers and exceed them. A strong CFO can manage this, but may be in for a battle with the CEO. As a bottom line, always be sure you'll hit the numbers in near-term quarters.

Don't antagonize top talent. When key executives leave in the midst of a capital raise, it's usually a self-inflicted wound. Team cohesion is important to a smooth process. And CEOs who want to make staff changes should do it before the financing process starts.

3. Business transitions: it's a slippery slope to the next level

A private technology company wins key customers and grows revenue fast with its leading-edge product. It attracts an acquisition offer that would produce a nice return for investors, but the board opts to pursue an IPO instead. Then the company's follow-on product is late to market due to indecision on product specs. Revenue stalls. The IPO is scrapped. The CFO leaves, and the controller and others follow. Accounting closes are late, audits for two fiscal periods do not get completed, and a $2 million government subsidy sits uncollected because of incomplete documentation.

M&A deals and IPOs generate upheaval even when they proceed without a hitch, so whenever obstacles pop up, the chances of chaos are high. Product failure is one obstacle that can throw a transition deal into disarray; others include a lack of finance preparedness, ugly facts that turn up during due diligence, and a competitor seizing market share. Whatever the obstacle (and often several are in play), the result usually is some combination of layoffs, poor morale, key people abandoning what they see as a sinking ship, and reduced valuation.

An experienced third party can sometimes provide a clearer view when development seems to be going off track.

The situation above got worse before it got better. The company was without a CFO for several months, and when an interim CFO came on board, he didn't hire enough replacement staff. The company remained stalled. Finally, the board hired an experienced permanent CFO, who brought in expert consultants to complete the audits, prepare for the current-year audit, and make accounting closes consistent and timely. They also helped the company collect the $2 million receivable, train sales and operations on deal terms for revenue recognition, and prepare a bottoms-up revenue and spending forecast. The board was then able to sell the business to a larger public company, although at a loss to investors.

Other than taking a good offer when it's sitting on the table, what can a company do to prevent this sort of slide? In the startup environment, a company's management and board often are so attached to a product that it's hard to stand back and evaluate it critically, and it's even harder to pull the plug. The company in the case above had trouble defining what customers wanted and matching that to what it could develop in the time frame customers expected. In situations like this, an experienced third party can sometimes provide a clearer view when development seems to be going off track.

Still, product problems and market shifts aren't always predictable (see problem No. 1). What you can be certain of is that if you keep your finance house in order, you'll be able to act on opportunities, get your best valuation, and retain some flexibility should misfortune strike.

To be ready for either an IPO or an M&A transaction, companies should build a core finance and accounting team that's competent in managing day-to-day business and budgets, and bring on experienced outside resources to help them get over the hump of a transaction. These kinds of deals require expertise that the core finance team in most companies doesn't have (and doesn't need in the normal course of events).

The team should work closely with the sales staff to ensure that transactions meet rev rec requirements, are fully documented and archived, and are tested quarterly. They should be prepared to provide due diligence documents at a moment's notice, get audits and tax filings up-to-date, and make sure IP attorneys are keeping patent and trademark filings current.

For companies that are IPO candidates, it's also important to:

- Prepare financial statements on a quarterly basis and obtain auditor reviews.
- Obtain 409A preferred and common stock valuations on a regular basis and have the board use them in setting stock-option exercise prices.
- Have the tax provision prepared by a different provider than the auditor, as public companies are required to do.
- Recruit board members who meet SEC and stock exchange requirements for independence and technical competence. Recruit early enough so that they have time to learn the business and can contribute when the IPO arrives.
- Engage an audit firm with ample public company experience.
- Analyze operations from a risk management standpoint, and implement and document internal controls to be ready for SOX discipline.
- Ensure that the accounting or ERP system is adequate for the next growth horizon.

Check out our *Ace Your IPO Filing* report for in-depth tips on preparing for an IPO.

4. Shifting strategy: changes in direction can knock a company flat

A new CEO takes the reins and wants to break from his predecessor. He decides to dramatically shift the company's strategic direction, shutting down some divisions and accelerating investment in others, looking for acquisition targets as opposed to growing organically, bringing in new executives, and letting employees know that either they are 100 percent on this bus or it's time to get off.

Chaos ensues. Investors don't understand the new direction, and the stock price plunges 60 percent in six months. Employee turnover jumps. The CEO and management team bicker over acquisitions. The business doesn't grow.

A change in strategic direction can occur whenever there's a leadership change, when competitive pressures require it, or when management needs to focus on either short- or long-term needs at the expense of the other. The situation doesn't have to cause chaos, but all too often it does. The primary reasons:

- The change in strategic direction launches before there's a tactical plan for achieving it.
- The CEO or executive team underestimates the time needed to implement the changes.
- The company doesn't communicate fully or persuasively about the reasons for the change, the benefits, and how it will execute the new direction.

As a result, the shift to the new strategy is rocky; the market gets confused or doubtful, and investors flee; customers get nervous and may delay buying decisions until the new direction takes hold; and employees feel anxious about their position or unsure of what they are doing, and start job hunting.

Once these negative trends set in, the company is looking at recovery not just from a stumble, but from a full-on face plant. In the situation above, the CFO significantly increased investor relations activity to try to calm the markets, stabilized the finance department by increasing communication, and led the management team to approach key board members about addressing the problems. Ultimately, the board corrected its mistakes of hiring the wrong CEO (a rookie and an outsider) and letting him impose a new strategic direction without fully understanding the consequences, and a new CEO stopped the madness, and then reset and settled the company's direction. But the whole process took a year and a half and did immense damage, both internally and with the financial markets.

Companies can avoid situations like this at the board level by insisting on detailed consultation with the CEO before making major strategic changes, at the CEO level by gaining management team buy-in, and at the management team level by working through the main tactical aspects of a change in direction before announcing it and ensuring that they have a strong communications plan in place. The company should be prepared to address potential concerns before they arise.

5. Talent shortfall: lack of key people creates widening finance holes

Cost-cutting and budgeting decisions result in an understaffed finance department. With the business growing organically and through M&A, the executive team clamors for more data and analytics. Most of the finance team struggles to meet 80 percent of their job requirements with one star performer filling the gaps—there's no time to transfer skills, mentor, or coach. He sees a better, saner opportunity and grabs it. Others see the yawning gaps and flee after him. The gaps get bigger.

Several tendencies endemic to Silicon Valley can lead to chaos-generating finance talent shortfalls like the one above: an insistence on running ultra-lean beyond the point where that's necessary (the startup phase or a short-term fiscal crisis); a habit of hiring underqualified people because they're cheaper (hey, they'll figure it out, right?); failure to staff for growth, regulatory changes, and business transitions; and a tight finance talent market that leads to long recruitment times.

A number of situations can cause a finance department to buckle at the knees.

Under these circumstances, a number of situations can cause a finance department to buckle at the knees:

- Your business is growing, you can't find the talent you need, and your current staff can't keep up with the work.
- Your high-performing contributor gets an offer he can't refuse, and you haven't planned for succession.
- You are implementing a new system, and the added workload is killing your team.
- Changes in regulations create a compliance burden you're not staffed to handle.

Often a key departure can adversely affect both the department's culture and its workload, causing a domino effect of more departures. An overworked staff makes mistakes, burns out, and seeks greener pastures. The problem is compounded when the person leaving is the only one with a specific skill or knowledge, or wears so many hats that a single new hire can't readily replace them.

The consequences of a talent shortfall can be severe for the business: improper revenue recognition, incorrect accounting treatment for complex transactions, and inaccurate SEC reports, to name a few. We've also seen companies in this situation discover inadequate inventory and warranty reserves and significant material weaknesses in internal controls. It's all bad news: these kinds of problems can lead to increased external auditor scrutiny as well as higher audit fees.

On top of that, executives may not get the business analytics and financial information they need to run the business. The company may miss or nearly miss SEC deadlines and fail to complete a key transaction (financing, an IPO, an acquisition) on a timely basis, leading to a loss of confidence in its financial information and a decreased business valuation.

As you might have noticed, a talent shortfall played a role in most of the chaotic situations described in problems 1 through 4. In the example above, the key employee was not an effective advocate for getting the resources he needed, and the company did not acknowledge or understand the many hats he wore. Finding a replacement was a tall order—the company now had a chaotic situation with scant resources.

A permanent fix to such problems takes time. In the short term, you can fill the gaps and begin to repair the damage with experienced consultants. Once you figure out what your true needs are, you face a decision: buy or build? Some talent is painfully scarce—do you pay a king's ransom to headhunt for what you need, or do you invest the time to train someone? Or do you split the difference and hire people who can do 80 percent of the job, and then develop them to learn the rest? The risk of training, of course, is that the person could leave before you recoup your investment—so now is the time to start building the culture that will keep them.

As usual, the best solution is prevention. Think strategically about where your business will be 18 months from now. (We know, it can be hard to see three months ahead at times, but take a stab at it.) Make sure your systems and people can grow with your business. Have a succession plan for key people. And, most important, foster a positive culture that encourages continuous learning. Provide opportunities for personal and career growth, such as job rotations and mentoring, and build in ways to reward top contributors.

Get more insight on keeping top talent in our *Wanted: Finance Superstars* report.

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Living with chaos—or looking to avoid it?

RoseRyan gurus can help. Our agile finance pros have been dodging falling rocks, putting them into neat piles, and building solid finance foundations for years. We can help you create a practical ERM program, get your finances in fundraising order, execute a smooth IPO or sale, or fill key finance positions. Contact Maureen Ryan at mryan@roseryan.com to find out how.

About the authors

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