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CHAPTER 1
Introduction and study design

CHAPTER 1
INTRODUCTION AND STUDY DESIGN

"No matter what the state of the economy, no company is immune from internal hard times – stagnation or declining performance".

Hofer (1980:19)

1.1 INTRODUCTION

Turnaround management, as observed in the South African context, is a new management discipline that is currently being robustly pursued by both business and academics alike. In this regard, the imminent date for implementation of the long-awaited rescue legislation has created many opportunities, which have resulted in a rush for the most favourable positioning in this 'newborn' industry in South Africa. In a proposed turnaround, the first salient decision to make is to either follow the formal route, as prescribed by legislation in "Business Rescue and Compromise with Creditors" Chapter 6 of the Companies Act (Act 71 of 2008) or to adopt an informal approach to turnaround. The Companies Act, Act 61 of 1973, will be referred to as the old Companies Act, and the Companies Act, Act 71 of 2008, will be referred to as the new Companies Act.

Interchangeable use of the following words, depending on the original author referenced, to describe "company":

Company = Business = Organisation = Venture = Business

The alternative of an informal approach to turnaround is prescribed by the International Association of Restructuring, Insolvency and Bankruptcy Professionals INSOL principles, as discussed by the United Nations Commission of International Trade Law's Multinational Judicial Colloquium (INSOL Professionals, 1995:35), and the so-called London Approach.

This study uses early warning sign theory to establish the verifier determinants that can guide entrepreneurs and turnaround practitioners in the critical role of timely planning for the current rescue and future sustainability of an enterprise. Although extensively explored later in this study, for now a verifier determinant is defined as a confirmation of an early warning sign.

Chapter 6 of the new Companies Act formalises business rescue via a formal commercial process that includes a consultative process and a moratorium period, and that maximises the likelihood of the company's continued existence on a solvent basis. Current formal turnarounds are based on those methodologies and/or actions that have already been recorded and tested in courts of law via Sections 311 and 427 of the old Companies Act and South African Insolvency Law, Act 24 of 1936. Consequently, this research identifies and discusses a number of models, or rather turnaround actions, of turnaround planning. Currently, there is little by way of guidelines or recorded turnaround plans in South Africa that addresses "verifier determinants".

Bolton's London Approach (2003:52) has its main application in the bank syndicates of informal consortia that attempt to restructure a business's debt. He makes it known that this process is "confined to bank lenders, conducted in secret negotiations, and generally involves both a temporary stay on bank debt payments and a pro-rata debt forgiveness ('hair-cut')". Iskander, Meyerman, Gray and Hagen (1999:43) advise that the London Approach has been in use in the United Kingdom since 1989 and has become well known across the globe.

Although the method for investigating a business is not prescribed or explained by law, the requirement to "investigate" the affairs of the company is a clear rule of law. For example, Section 141(1) of the new Companies Act reads as follows: "As soon as practicable after being appointed, a practitioner must investigate the company's affairs, business, property, and financial situation, and after having done so, consider whether there is any reasonable prospect of the company being rescued."

With very limited time available to construct a business rescue plan, the practitioner will need to develop a unique modelling process in order to be in a position to formulate the rescue plan. A turnaround practitioner will most probably be appointed whatever strategic approach the entrepreneur (board of directors and/or shareholders) decides on. The appointment (formal or informal) of a turnaround manager is made primarily by the board of a company and is sanctioned by the stakeholders.

Section 128 of Chapter 6 of the new Act describes the stakeholders as affected persons who are shareholders, all classes of creditors' organised labour, staff and any other party that may be affected. In formal proceedings, stakeholders will also be in a position to appoint or to remove a practitioner through a court-driven process.

The following are examples of theories and models that address the actions of turnaround practitioners:

Eisenhardt (1989a:58) encapsulates the agency theory. Agency theory concerns the relationship between a principal and his/her agent. Effective turnaround management requires quick decision making in the early stages of distraught circumstances. The appointment of a turnaround practitioner is done with the expectancy of a close relationship between a principal (shareholder/s, director/s and/or stakeholder/s) and a manager (in a turnaround context this is the turnaround practitioner). Eisenhardt (1989c:544) discusses the making of fast strategic decisions in high-velocity environments. However, without a sound strategy, Hedley (1976:2) is convinced that corporate survival itself may be called into question. It can thus be deduced that the practitioner in his/her role as appointed agent must be in a position where he/she is mandated by the principle of taking quick and decisive decisions. This will include formulating short and medium-term strategies.

Hofer (1980:19), and Hambrick and Schecter (1983:235), on the other hand, debate the steps taken at the commencement of a turnaround. They argue that a turnaround starts with cost-cutting exercises, although they omit to discuss the very first step in a turnaround event, that of analysing the business.

Other researchers and authors, such as O'Neill (1986), Boyle and Desai (1989, 1991), Gopal (1991),Hubbard, Lofstrom and Richard (1994), Oliver and Fredenberg (1997), Castelli and Kontoyianni (1999), Theriot, Roopchand, Stigter and Bond (2000),Collard (2002) and Fetterman (2003), concentrate on the analysis phase as the initial step in the process of turnaround. They promote the importance of understanding the turnaround event before embarking on steps commonly referred to as "stopping the bleeding". Bruton, Ahlstrom and Wan (2001:148) argue that the business must stop the bleeding through retrenchments and immediate "cut-backs".

Pearce and Robbins (1993:624) agree that stabilising the business (stopping the bleeding) is the first stage of turnaround. Moreover, they emphasise the second phase as being the "recovery response". This recovery response in the turnaround process highlights the effective correction of the root causes of the decline.

Meanwhile, Chapman (2003) criticises the relatively short period of one month available to Australian companies to come up with a turnaround plan. This time frame is closely related to the length of time prescribed for the rescue process (25 days) in South Africa, as described in Chapter 6 of the new Companies Act. Al-Shaikh (1998:81) ponders on the steps in turnaround as being firstly the conducting of feasibility studies and then securing support from interested authorities, such as lenders and trade creditors.

The subtle balance required in the initial stage of a turnaround is critical for managing a chaotic environment. Moncarz and Kron (1993:180) advocate the identification of problem areas as the first step to turnaround. Balgobin and Pandit (2001:304) state that the four elements aiding a successful turnaround strategy are:

- situation analysis
- gaining control
- managing shareholders
- improving motivation.

Cross (2002:41) advocates the initial analysis of a company's performance concerning its finances, operations and market. Fetterman (2003:11), Glantz (2003:323), Scherrer (2003:27), Lohrke, Bedeian and Palmer (2004:172) and Burbank (2005:56) agree that the first stage of a turnaround is a situation analysis. Cole (1994:48) underpins the importance of data integrity in the initial stages of a due diligence (see section 1.2.1).

Cole (1994:48) states that it is crucial to get entrepreneurs to understand that providing high-quality information will speed up the process. This study concentrates on the validation of the problem areas, or warning sign areas, identified. Gilmore and Kazanjian (1989:81) distinguish between group and individual decision making. From a turnaround perspective, both these types will have value, but as most turnarounds require an autocratic approach the individual decision types will have more influence. In the analysis phase, selecting the process format of the analysis is the most crucial decision in a turnaround event: this decision is whether to attempt the turnaround or not.

The turnaround practitioner in South Africa must, within 25 days of being appointed, construct a turnaround plan, which must be adopted by all stakeholders within ten days of publication of the plan. Figure 5.1 in chapter 5 illustrates the timeline requirements of the Act. In this regard, Merrifield (1993:384) proposes a disciplined analytical process before a turnaround process can commence. Although traditional methods of analysing a business should suffice, the time constraint is an important consideration.

The intention of this research is to design and develop a framework to enable practitioners to function within this time constraint, as well as the prescriptions of the new Companies Act.

1.2 CURRENT METHODS OF BUSINESS ASSESSMENT

1.2.1 DUE DILIGENCE

The most common and most generally accepted method for analysing and testing the feasibility of a business is perhaps the "due diligence" method. A due diligence process is used by business analysts to analyse and test the assiduousness of a business venture and is the process predominantly applied in merger and acquisition considerations. Cole (1994:46) lists the following critical due diligence elements:

- successor environmental liability
- integrity of business's historical financial statements
- adequacy and sufficiency of assets
- intellectual property, patents and know-how
- technical expertise
- quality of all personnel and key management
- quality of projected cash flow and after-tax earnings

Hubbard, Lofstrom and Richard (1994:1) confirm the importance of a due diligence process, but warn that companies have little guidance on what constitutes a good due diligence process and are restricted to their own experience. It is imperative that the due diligence process is done within a very short period as, in a turnaround event, very little time is available to "fish" for information.

1.2.2 BUSINESS REVIEW

Akason and Kepler (1993:38) have set some guidelines for a management review, which are also applicable to turnaround planning. They ponder on their finding that a business review "goes far beyond mere due diligence processes" and differentiate a due diligence from a business review by calling a due diligence a "cookbook approach" or a reactive process using a checklist indicating "yes" or "no" decisions.

However, Akason and Kepler (1993:38) opines that a business review, if correctly executed, covers everything in the business it is a “proactive process that generates a live, working document that can be used in a value-creating manner” and can be used as a management tool in the future.

1.2.3 VALUATION METHODOLOGY

The two most important questions that need to be answered when a turnaround event occurs are the following:

1. In a distressed business scenario, should a turnaround be attempted or not?

2. In a distressed business scenario, will the turnaround have the desired results?

Hence, the most important decision the practitioner must consider is whether there is a reasonable prospect for continuing with the business. Accordingly, after a turnaround practitioner has been appointed he/she must establish the feasibility of turning the business around.

Chapter 6 of the new Act, requires the turnaround practitioner to “**consider** whether there is any **reasonable prospect of the company being rescued”** (researcher’s emphasis).

The answer to considering a “reasonable prospect” lies in evaluating the business as a going concern. Grounded theory by Hershkowitz (2004) was used to investigate various valuation methods and their applicability. Referring back to the two questions mentioned at the beginning of this section, a solvency (liabilities exceeding assets) versus liquidity (non-cash working capital cycle) or cash flow (ability to generate cash to meet short-term obligations) valuation is suggested to satisfy question 1. Bolton (2003:43) discusses the significance of a valuation as the first stage of a turnaround event and identifies some important “transformation” steps in an attempt to preserve the business:

- Preserve the liquidation value of the business.
- Maintain the going-concern value of the business.
- Form committees to conduct restructure negotiations.
- Negotiate new funds.
- Take note of modern reorganisation law.

The main inference from Section 141(1) of the new Companies Act is that the turnaround practitioner has to confirm (with the stakeholders) the status (solvency and liquidity position) of the business, regardless of which route he/she anticipates embarking upon. Briggs (in Cross 2002:44) confirms that in a turnaround situation there cannot be any sacred cows. She concludes with a question to the entrepreneur: “Are you willing to sign a document that states that everything is on the table? If not, I will leave now and you are on your own.” In closing, the above methods are processes that have been tested and proven in various applications but are now being applied to a turnaround event.

The main constraint of the measures discussed above is time – they are excellent processes if the analyst has the luxury of time. In conclusion, it should be stated that turnaround modelling should address, as its main departure point, the time limitations imposed by Chapter 6 of the new Act.

1.3 TURNAROUND TRIAGE

In medical terms, Moskop and Iserson (2007:276) describe three basic steps for traige:

- The scarcity of resources which will prompt a process of triage.
- The triage officer assesses patient’s medical needs by conducting a brief examination.
- The triage officer then uses a set of criteria to implement a priority treatment plan.

Moskop and Iserson (2007:276) conclude that, if the triage officers use an established plan, it confirms that a group of persons must have developed the plan. Crawford (1994:27) supports the triage approach when he states that the turnaround practitioner must perform an on-site “brutally frank assessment of the company’s condition”. He refers to this action as “on-site triage”.

This study refers to this very first stage in a turnaround situation as “turnaround triage”. The term ‘triage’ has its foundation in World War I, and is derived from the French word *trier* meaning ‘to sort’. As explained by Moskop and Iserson (2007:275), triage was used exclusively by the medical fraternity. However, medical triage has a very close affiliation to turnaround triage. Table 1.1 illustrates the difference between medical triage and business triage as identified by this study.

Table 1.1 Comparison of medical triage (Moskop & Iserson 2007:279) and business triage (own compilation)

MEDICAL versus BUSINESS TRIAGE	
• **MEDICAL TRIAGE**	• **BUSINESS TRIAGE**
• a) Those patients who can be saved but whose lives are in immediate danger, requiring treatment immediately or within a few hours (red triage tag: “immediate”; priority 1)	• a) Those businesses who can be saved but whose sustainability is under immediate threat , (financially distressed) requiring turnaround immediately or within a limited time span (red triage tag: “immediate”; priority 1)
• b) Those patients whose lives are not in immediate danger but who need urgent but not immediate medical care (yellow triage tag: “delayed”; priority 2)	• b) Those businesses whose sustainability is not under immediate threat(financial distressed within next six months) but who need urgent intervention but not immediate turnaround (yellow triage tag: “delayed”; priority 2)
• c) Those patients requiring only minor treatment (green triage tag: “minimal”; priority 3)	• c) Those businesses requiring only minor intervention (green triage tag:“minimal”; priority 3)
• d) Those patients who are psychologically traumatized and might need reassurance or sedation if acutely disturbed (no specific triage tag)	• d) Those businesses who are still profitable but psychologically traumatized and might need new strategic direction –informal turnaround (no specific triage tag)
• e) Those patients whose condition exceeds the available therapeutic resources, who have severe injuries such as irradiation or burns to such an extent and degree that they cannot be saved in the specific circumstances of time and place, or complex surgical cases that oblige the physician to make a choice between them and other patients (black triage tag: “expectant”; no priority)	• e) Those businesses whose financial distress exceeds the liquidity and solvency tests , to such a degree that they cannot be saved in the specific circumstances of time and place (gone concern) (black triage tag: “expectant”; no priority)
• This last category, “expectant,” which encompasses those who are dead or who are “beyond emergency care,” carries the most emotional and ethical baggage for individuals doing triage.	• This last category, “expectant,” which encompasses those businesses who are gone concerns who are beyond turnaround intervention.

Answers to the following three basic questions, in this specific order, are the most important aspects to consider when contemplating a business turnaround:

- Is there a business? (Harker and Sharma, 2000:41)
- How sick is the business? (Castogiovannii, Balga and Kidwell, 1992:27)
- Is the business worth saving? (Quinn, Mutzberg and James, 1988:680)

Pretorius (2008a:23) discusses Porter's five strategic forces in a turnaround context. Figure 1.1 illustrates his views on turnaround theory, where turnaround situations are depicted in the four quadrants.

Pretorius approaches the turnaround situation by placing the business under consideration in one of the quadrants. The shaded oval drawn across the four quadrants illustrates the concept of "business triage".

The shaded area represents the turnaround area, which is to a greater or lesser extent evident in each quadrant. To give an example, in the 'performing well' quadrant, the obvious mistake would be to ignore early warning signs. Who would expect a business to experience distress in this quadrant?

Nevertheless, a turnaround intervention may at some time be necessary in this quadrant, as such businesses are prone to overtrading. Overtrading is one of the most dangerous situations a business can find itself in.

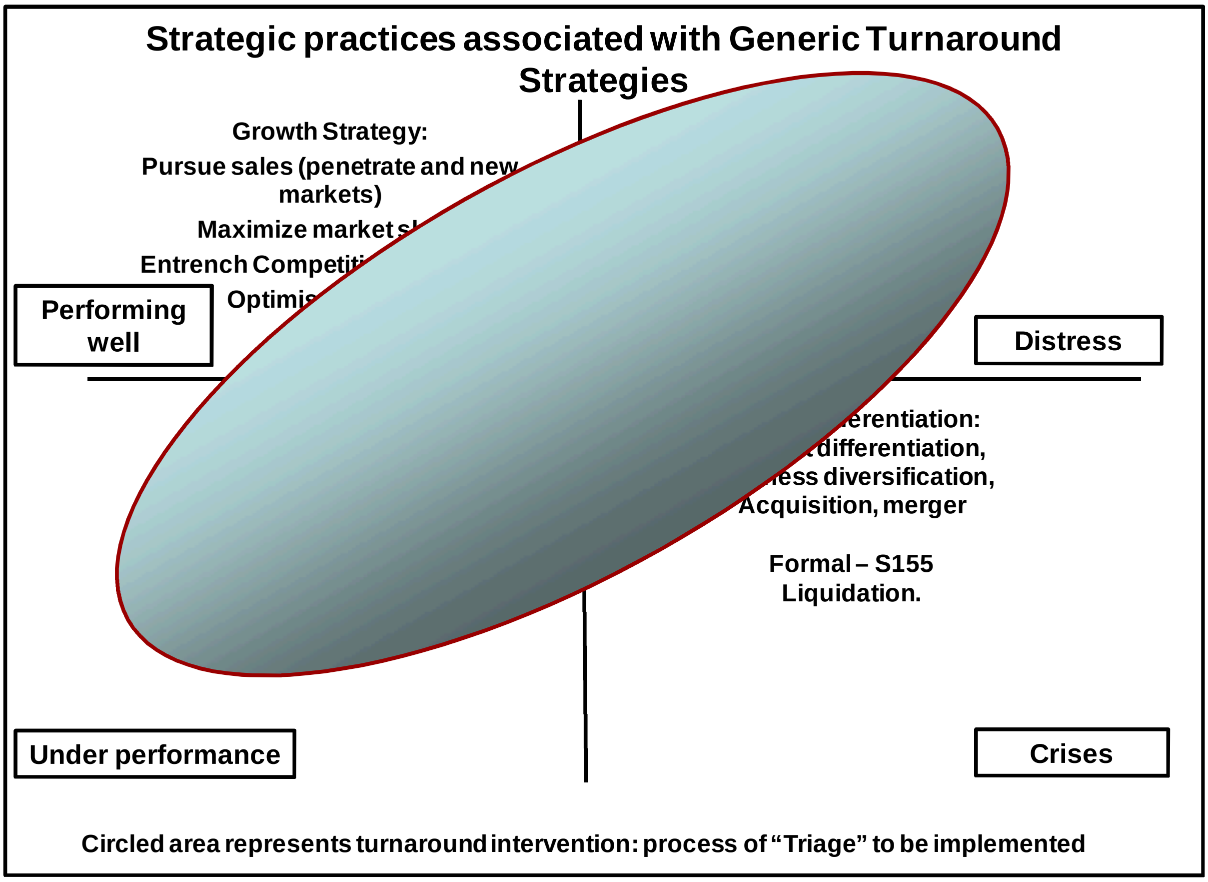

Figure 1.1 Verifier strategic practices associated with generic turnaround strategies and triage (adapted from Pretorius, 2008:24)

1.4 MOTIVE FOR THE STUDY

The motive for this research vests in management's dilemma, which the board of a company may resolve according to Section 129(1) of the new Companies Act, that is, that the company should voluntarily begin business rescue proceedings. If management fails to adopt a resolution in this regard and if the board of a company has reasonable grounds to believe that the company is financially distressed, the board must set out its reasons for not adopting a resolution in terms of Section 129(7) of the Act.

The general deduction from this sequence of events is that entrepreneurs (management and/or directors) will be forced to continuously analyse their businesses.

Currently, apart from the prescriptions of Chapter 6 of the new Companies Act, there is no acknowledged turnaround model available to entrepreneurs and turnaround practitioners that is appropriate for application within the time constraints of the Act. To add to this problem, legislation in its current and future form does not provide entrepreneurs with any protection concerning informal turnaround attempts. Chapter 6 of the new Companies Act, Act 73 of 2008, addresses the problem of formal turnarounds, but this new Act still requires testing in the courts.

Section 128(b) (i–iii) of the Companies Act describes business turnaround as follows:

Section 128(b) ***"business rescue"*** *means proceedings to facilitate the rehabilitation of a company that is financially distressed by providing for—*

(i) *the temporary supervision of the company, and of the management of its affairs, business and property;*

(ii) *a temporary moratorium on the rights of claimants against the company or in respect of property in its possession; and*

(iii) *the* ***development and implementation, if approved, of a plan*** *to rescue the company by* ***restructuring its affairs, business, property, debt and other liabilities, and equity in a manner that maximises the likelihood of the company continuing in existence on a solvent basis*** *or, if it is not possible for the company to so continue in existence, results in a better return for the company's creditors or shareholders than would result from the immediate liquidation of the company.*

This gives rise to the question: How can entrepreneurs react to early warning signs in order to attempt corrective action and effect turnarounds in time, and if need be, as per Section 129(1) of the Act, appoint a professional turnaround practitioner? When a turnaround event in terms of Chapter 6 of the Act occurs, the dilemma facing the entire body of role players and/or stakeholders is whether to commence with a turnaround of the affected business or not.

Referring back to the three crucial questions stated earlier, the following questions have to be answered:

- Is there a business?
- How sick is the business?
- Is the business worth saving?

Brenneman (1998:162) adds another valid question to the three questions above, asking: “When did it last make money?”. The primary objective of a business venture is to be profitable, thus to make money. In this regard, the affected persons will firstly be management, as they have to decide on what Brenneman (1998:165) calls a “go forward plan” or turnaround strategy. Moreover, all the creditors (all categories) will have to be convinced that the business has the potential to survive after informal, or formal, proceedings in terms of Chapter 6 of the Act.

Finally, if the feasibility of attempting a turnaround is challenged, the courts will have to be satisfied that a business can in fact be turned around, before ruling in favour of the turnaround.

1.5 VERIFIER DETERMINANT THEORY

Correctly identifying the causes of a business’s decline through the application of early warning sign theory is of the utmost importance in effectively addressing the question of whether or not to continue with a business turnaround strategy. At this stage, the suggestion is that the turnaround decision is one of the very first steps in the turnaround process.

The focus, however, is on the development of a plan by practitioners in conjunction with management. This plan should be specifically designed to reorganise the business.

Less evident are the measures to confirm the signs once identified. These events are identified as “verifier determinants” (the construct). At this stage, this is still an unfamiliar concept and is therefore explored by this study.

This study pursued the following course of action:

1. Theoretically define the construct “verifier determinant”.
2. Identify verifier determinants that will authenticate early warning signs in a specific time frame.
3. Strategically identify and action corrective measures.

Propose concepts to be included in the turnaround model.

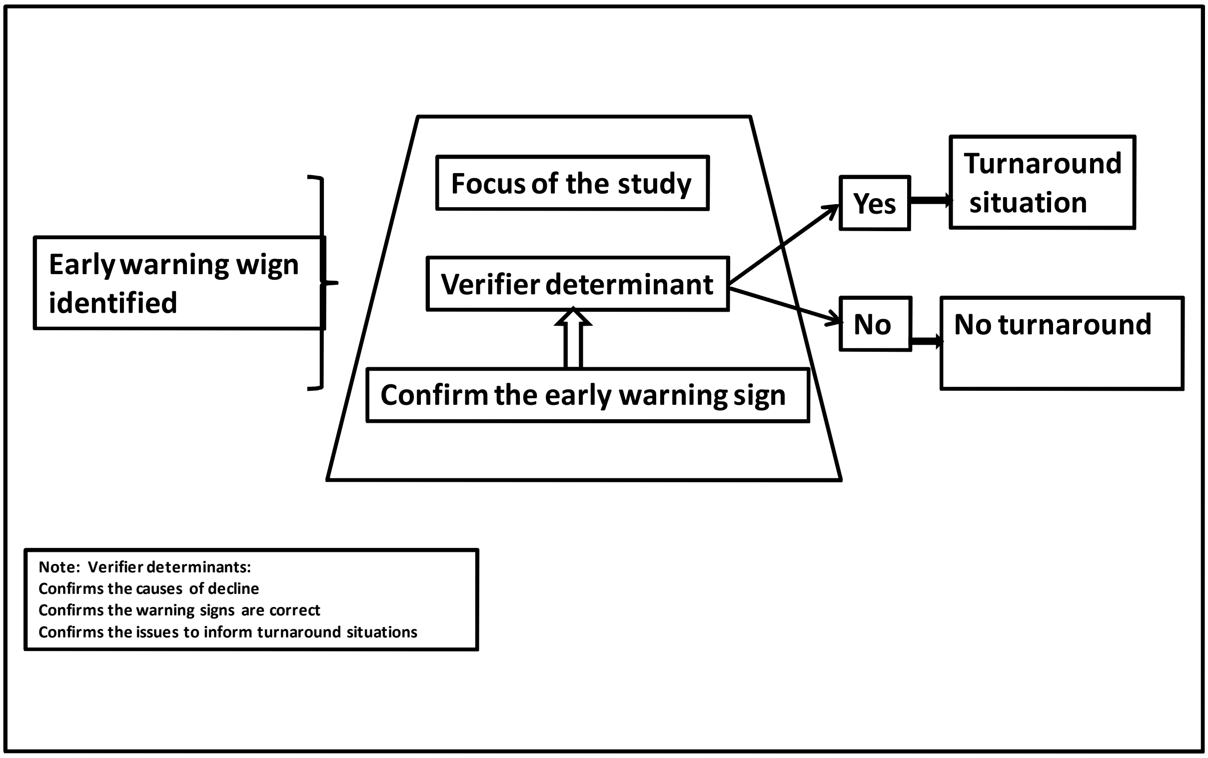

Figure 1.2 Verifier determinant theory as applied in this study

The importance of this study is emphasised by the uncertainties that the following three statements present:

1. Entrepreneurs are not likely to know what the construct “verifier determinant” is or whether it will confirm a specific set of early warning signs.

2. The question to be asked is whether there is a common understanding among lending practitioners (mainly bankers) of the construct “verifier determinant”?

3. Are verifier determinants in evidence in distressed businesses to initiate or to take corrective action in good time? Measured by the number of businesses in liquidation, the answer is clearly “no”.

Verifier determinants, once identified, impact significantly by authenticating warning signs and can be used progressively in the diagnostic phase of the turnaround process. The effectiveness of business turnarounds depends on the strategy chosen and the verifier determinants will be an important strategy component.

The literature review in this research deals with the following aspects: early warning signs, failure models, legal constraints/opportunities and, finally, turnaround. The empirical study aims to propose a functional turnaround model as a basis for attempting turnarounds. Figure1.3 outlines the topics discussed in each of the chapters in this study.

Thus, chapter 2 deals with the high-risk propensity which is a characteristic of entrepreneurs. Chapter 3 deals with the available literature on early warning signs; this was scrutinised to ensure that all current and available literature is included. Subsequently, the literature and theory on turnaround processes, strategy and actions are investigated in chapter 4. Finally, chapter 5 covers the legal systems of foreign countries, such as the United States of America and the European Union. Accordingly, the laws of these countries and their interpretation are scrutinised.

Figure 1.3 graphically displays the process followed in the literature research and in the chapter layout.

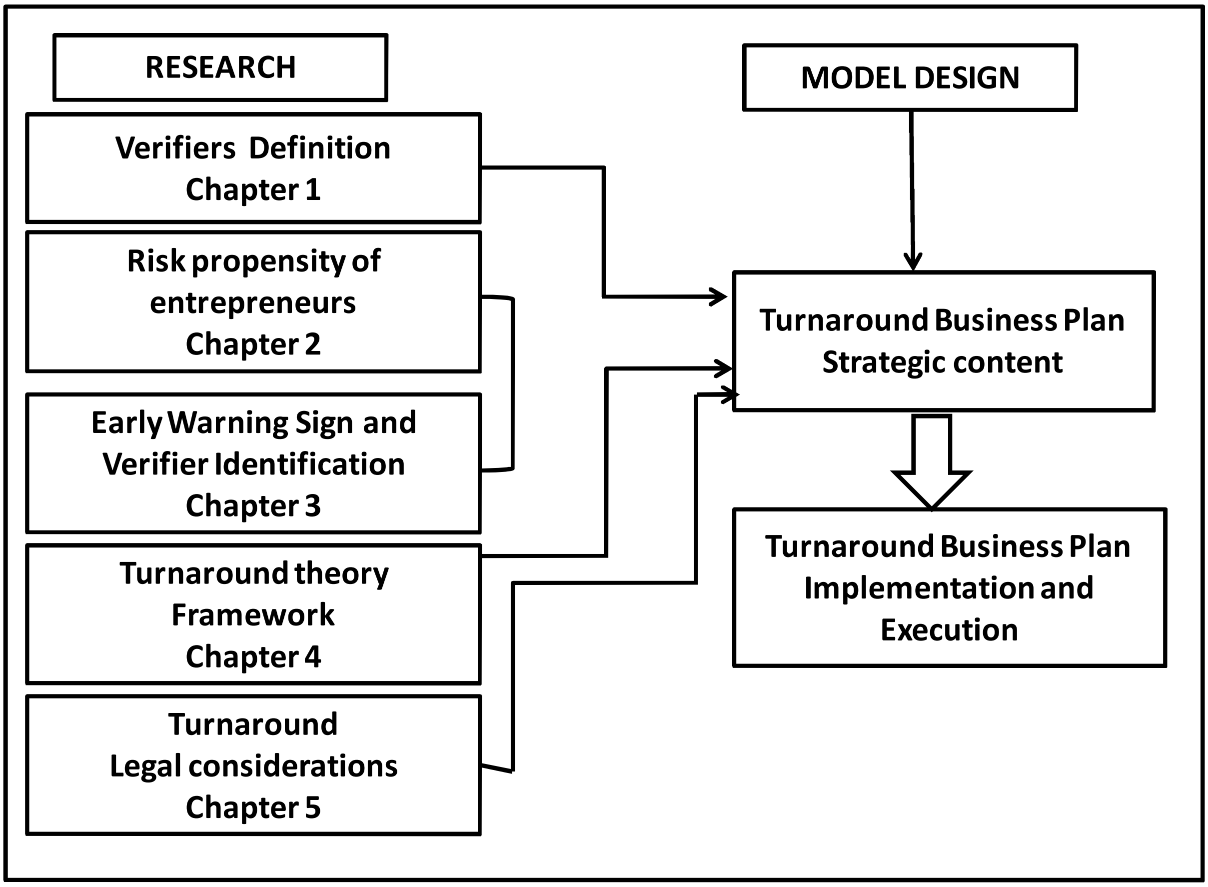

Figure 1.3 Literature chapters and topics covered in this study

1.6 RESEARCH OBJECTIVE

The following objectives of this research are outlined:

1.6.1 PRIMARY OBJECTIVES

- Identify and theoretically define early warning "verifier determinants".
- Identify and include verifier determinants as an integral part of a turnaround plan that supports corrective action.

1.6.2 SECONDARY OBJECTIVES

- To research the current formal turnaround practices for verifiers, including those of the United States of America, Canada, Australia and Africa, and the informal practices evident in South Africa. These findings are aligned to include the changes in the applicable South African legislation.

- To design and propose a framework for use by turnaround practitioners and entrepreneurs alike.

- To identify which verifier determinants will confirm the early warning sign, and apply this outcome to the design of a reliable turnaround framework that is accepted by all creditors and financial institutions.

- To contribute to the South African entrepreneurial, turnaround fraternity, and to future formal studies in this academically ill-represented field.

The research conducted an investigation into various early warning signs, turnaround management, and legal constructs and elements. One of the major changes in legislation that needs to be considered here is that the turnaround of a troubled business must first be attempted before winding up or liquidating the concern. King (2009) includes this provision in the King III report on corporate governance.

Although not enforceable by law, the King II and III reports are considered the rule for corporate governance in South Africa (Lawlor and Haynes, 2003:13). A suggestion is that the new legislation follows a model such as Chapter 11 proceedings in the United States of America (Corporate Law Reform, 2004:42). The intention to follow international legislation is manifested largely in Chapter 6 of the Act. The main objective of new legislation must be that the entrepreneur and the turnaround practitioner develop a turnaround plan that is specifically designed to reorganise and rescue the business.

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1.7 PROBLEM STATEMENT

The possibility of business failure in a high-risk environment is a fact that entrepreneurs frequently need to face. Pretorius (2004:260) mentions that between 30 to 80% of all new businesses fail within two years of inception. Decline is, however, not limited to the first two years, as it can happen at any time during the business's life cycle. The early warning signs of business failure were and still are the main topic of research in this area (see also section 3.2).

Literature on early warnings signs indicates that researchers, such as Lorange and Nelson (1987), Boyle and Desai (1981), Scherre (2003), also identified the causes of the warning signs. What needs to be confirmed is the root causes of the decline. In this study a 'verifier determinant' is defined as the 'root' indicator that validates the cause of decline or distress that underscores the early warning sign These verifier determinants confirm the associated causes and early warning signs of business decline. Once identified and confirmed, the verifier determinants inform the turnaround situation. Ventures have different risk propensities and the question is whether turnaround practitioners or entrepreneurs can employ verifier determinants to confirm the distress causes in the businesses.

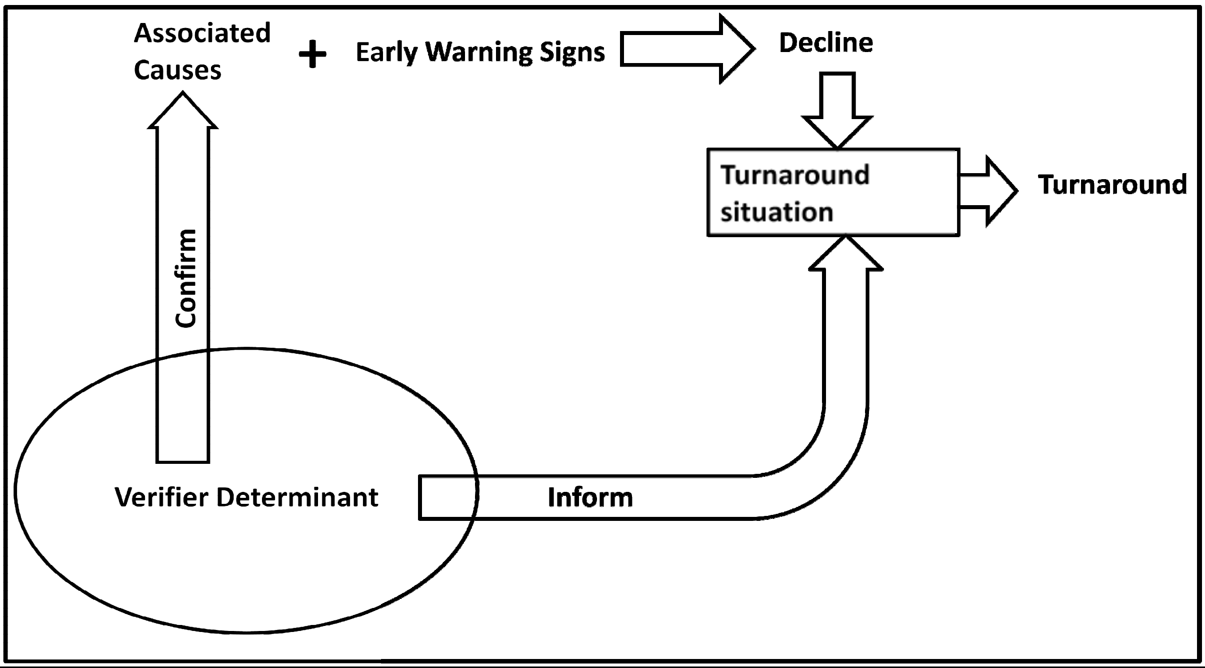

Figure 1.4 The role of verifier determinants in a turnaround situation

The entrepreneur's enterprise is more vulnerable due to a lack of understanding of the real value and efficient use of a well-constructed turnaround plan. This absence of a turnaround plan inevitably leads to default on financial commitments and possible business failure. Creditors place huge reliance on turnaround plans, as these plans will determine future support. However, if the compiler is not careful, under current legislation a proposed turnaround plan can be construed as an act of insolvency. In view of this, the changes in South African corporate legislation are expected to address some of these issues, but entrepreneurs and/or turnaround practitioners need to create "faith" in the concept of a turnaround plan.

Problem statement: To identify verifier determinants that will confirm early warning signs and causes, and inform turnaround plans through enhanced situation analysis.

A sound knowledge of the financial statements, the business's tax position and any failed strategy is vital for achieving turnaround success. Hence, verifier determinants confirm the integrity of the data to be used in a turnaround.

1.8 TERMS USED INTERCHANGEABLY IN THIS THESIS

Financial distress – distress, decline, failure

Turnaround – rescue, realignment, restructure, reorganisation, renewal

Stakeholders – shareholders, creditors, organised labour

Strategic planning – strategy-making, strategy format

Turnaround plan – the plan, strategic plan, rescue plan

Turnaround situation – turnaround event

Situation analysis – due diligence processes, feasibility, business review, business audit, analytical process

Early warning signs – causes of decline, root causes of failure, variables of success and/or decline

Business – company, venture, business, organisation

1.9 REFERENCING TECHNIQUE

The Harvard referencing system is used throughout this study.

1.10 CHAPTER OUTLINE

Chapter 2	*Risk propensity of entrepreneurial ventures*	This chapter explains the risk propensity of entrepreneurs and their physiological reaction to business turnaround events. The chapter concludes with a brief overview to the South African status quo on turnarounds.
Chapter 3	*Academic debate of identification of business decline*	This chapter outlines and explains the evolvement of warning signs and its field of application. Literature content illustrates the debate on business failure and decline.
Chapter 4	*Theoretical development on turnaround management*	The theoretical development flow of turnaround theory and philosophy, and the subsequent modelling of turnaround processes are embodied in this chapter.
Chapter 5	*A literature review on turnaround legislative measures*	This chapter deals with international trends in business rescue legislation. Discussions include the old and new South African legislation. The rescue requirements of Chapter 6 of the Companies Act, Act 71 of 2008, are discussed.

Chapter 6	*Research design and methodology*	This chapter explains the research problem, the objectives of the study and the hypotheses. Background to the case study selection and the questionnaire design is given.
Chapter 7	*Research findings*	This chapter reports the empirical findings from the data compiled from the questionnaires. The statistical analysis is explained in detail against the backdrop of demographical information and more descriptive inferences.
Chapter 8	*Conclusion*	The closing chapter proposes a framework for turnaround modelling, based on the empirical findings. The research is concluded by revisiting the hypothesis and research objectives. Future research areas are also proposed.

CHAPTER 2

Risk propensity of entrepreneurial ventures

CHAPTER 2
RISK PROPENSITY OF ENTREPRENEURIAL VENTURES

"When a company is in trouble, finding and understanding the sources of problems is not as simple as looking into a mirror."

Barker (2005:44)

2.1 INTRODUCTION

This chapter explains the risk propensity of entrepreneurs and their psychological reaction to business turnaround events. The chapter concludes with a summarised overview of the South African status quo on turnarounds.

2.2 RISK PROPENSITY OF ENTREPRENEURS

Business ventures are faced with the constant risk of decline. When the business is deteriorating, entrepreneurs often do not understand the problem, nor do they take it seriously, consequently, they do not take sufficient steps to address the problems. Counterfactual thinking and cognitive studies should be applied to the identification of deteriorating business activities. In addition, the psychological effect of deterioration, failure and turnaround is increasingly being incorporated into entrepreneurial cognitive studies. Sutton and Callahan (1987:412) investigated and discussed the spoilt image of the business and its management as a result of bankruptcy. For any economy, it is important that entrepreneurs re-enter the market.

In a Boston Consulting Group Report, Bose and Pal (2002:3) conclude that "entrepreneurs who can transcend failure and learn from their experience have proven to be precious assets to their country's economy: they drive growth and they create employment, and they do this more successfully than entrepreneurs who have never failed".

Amaral and Baptista (2007:2) state that an entrepreneur who re-enters the business arena after a business failure (or for any other reason) is defined as a "habitual" entrepreneur. According to these authors, a "…habitual entrepreneur is an individual who has established and/or inherited and/or purchased more than one business, as opposed to novice entrepreneurs who have established, inherited and/or only purchased one business…".

The concept of "risk taking" is closely associated with entrepreneurial behaviour. The entrepreneur's appetite to take on risk is illustrated through his/her management and leadership styles. Hatch and Zweig (2000:69) ponder the entrepreneur's rationalisation of high risk taking, and their diminished perception of the risk. Wickham (2004:17) indicates that entrepreneurial characteristics include

- the need for autonomy
- the need to be in control of a situation
- a desire to face risk
- creativity
- a need for independence
- the desire to show leadership qualities.

The process of entrepreneurship follows the various stages of the business life cycle. Researchers, such as Flynn and Forman (2001:43), Terpstra and Olson (1993:14), Kazanjian and Drazin (1990:138), and Platt and Platt (1994:117), conclude that an array of different problems can face organisations in various stages of their life cycle.

Following the business life cycle, it is clear that the entrepreneur will be faced with decline and/or failure somewhere in this cycle. Flynn and Forman (2001:54) argue that business failure relates to the entrepreneur's inability to adapt to the various stages of the business life cycle. Researchers such as Altman (1983:18) and Amburgey, Kelly and Barnett (1993:69) conclude that, in their research's data distribution with respect to the age of the business, the findings clearly indicate that the risk of failure is business age dependant and that more than 50% of all failures occur in the first five years.

Argenti (1976:15) identifies three categories of company:

- Type I businesses are launched but never take off and fail within a few years.
- Type II businesses are launched and soar to incredible levels and then collapse.
- Type III businesses are launched and mature, and then trade optimally over several years.

Amaral and Baptista (2007:4) argue that the entrepreneur’s survival is not dependant on the business’s successes and/or failures and draw a distinction between business survival and entrepreneurial survival. Holtz-Eakin, Joulfaian and Rosen (1994:53) examined the phenomenon that some individuals/entrepreneurs survive and others do not. Accordingly, they conclude that the undercapitalisation of ventures plays an integral part in the survival of entrepreneurs. Lohrke, Bedeian and Palmer (2004:63) discuss the important role of top management in periods of decline. They argue that for management to be successful in situations of decline, they should establish the cause of the performance lapse “...quickly and accurately...”. Identifying these causes correctly will determine the decisions made for prompt recovery or turnaround.

To ensure survival, entrepreneurs must be properly equipped to adopt a strategic turnaround approach. Azoulay and Scott (2001:340) argue that entrepreneurs will find it difficult or will be unable, to change their routines unless they firstly recognise those routines as being imperfect. It is important that these imperfections should be recognised in good time to ensure that the entrepreneur can still change them.

2.3 PSYCHOLOGY OF BUSINESS TURNAROUND

In the South African context, the entrepreneur usually “fails” in the business. Moreover, the way creditors secure themselves inevitably leads to the entrepreneur also being sequestrated as a result of mandatory personal suretyships.

The rehabilitation process, often protracted over ten years, effectively removes the entrepreneur from the business scene. Pretorius (2004:261) argues that the entrepreneur probably never contemplates failure, especially when starting a new venture. Entrepreneurial studies done by Forbes (1999:415) and Gaglio (2004:535) tend to focus on venture creation, opportunity identification and positive change and neglected decline and distress as part of the business cycle. Owing to the stigma of bankruptcy and failure, distress is often concealed from all the stakeholders. Argenti (1997:442) identifies five categories of stakeholder in debating stakeholders' approach to business; these are, investors, employees, customers, suppliers and the relevant community. According to Sutton and Callahan (1987:412), demise cannot be concealed for long and the facts can only be concealed for a limited period. Unfortunately, concealing the facts will lead to less time and increased difficulty in effecting a successful turnaround. It also has a serious psychological impact on the entrepreneur, directors and management of the distressed business.

Argenti (1997:445) is of the opinion that stakeholder theory of running a business for the benefit of all stakeholders is an impossible dream, a philosophically misconceived idea. This is contrary to what the South African government is trying to achieve by involving all role players ("shareholders" according to the Argenti definition) in the rescue of a business. Midanek (2002:22) argues that an entrepreneur's ego sometimes gets in the way. However, to rise to a successful level of top management or entrepreneurship requires confidence and a good measure of ego strength. Midanek ponders on this characteristic and concludes that this phenomenon, "high ego", causes the entrepreneur or manager to "see" the bigger picture. The driving force behind entrepreneurs is clearly identified by need theory, as identified by McClelland (1961), achievement motivation (n-ach), authority/power motivation (n-pow) and affiliation motivation (n-aff). Entrepreneurial organisations are further characterised by strong leadership and direction from the entrepreneur.

Wickham (2004:135) argues that an organisation's very survival depends on the leadership structure living its goals, as well as a focus on competitive locations. Using need theory, McClelland identifies the organisation as part of the motivational force of managers or entrepreneurs.

According to Quinn *et al.* (1988:83), the entrepreneur is driven, above all, by his need for achievement. The entrepreneur's organisational goal is simply the extension of his own goals. It is concluded that the dominant goal of the organisation operating in the entrepreneurial mode is growth, which is the most tangible manifestation of achievement. (A second motive closely related to behaviour in organisational settings is the need for power [n-Pow].) It would appear that the concept of a "high need for power" is associated with leadership and actual power, but only when it occurs in combination with certain other factors, as was demonstrated in the longitudinal study conducted by McClelland (in Robert, 1986:196). In his article "Characteristics of successful entrepreneurs", Dollinger (2003:38) states that, over the past few decades, entrepreneurial research has identified a number of personality characteristics that differentiate entrepreneurs from other people.

Similarly, McClelland (in Robert, 1986) identifies certain characteristics of entrepreneurs. He sees the individual entrepreneur as a promoter of his/her own career with a focus on strategies of advancement, and views entrepreneurs as innovative, independent people and moderate risk takers, whose role as business leaders conveys a source of formal authority.

Simons (1999:85) argues that businesses seldom consider risk management when times are good, profits are up, optimism is on a high, and markets are growing. In these favourable conditions, businesses tend to ignore early warning signs. It is also not clear when a business is going to "hit a significant bump" or if a major change in strategy is needed. Entrepreneurs need to understand the conditions that create unacceptable levels of risk and decline.

Early warning signs, failure prediction and its causes have been researched extensively over the past forty years. In light of the entrepreneur's high propensity to take risks, this study theoretically defines and uses verifier determinants in proposing a turnaround plan.

2.4 RISK PROPENSITY OF VENTURES

Wickham (2004:134) emphasises the entrepreneur as the main focus point for contingency in the entrepreneurial process. The decision-making process, and the acceptance of risk, thus centres on the entrepreneur's leadership ability. Pretorius (2004:261) argues that achieving personal goals is the driving force for entrepreneurs to start businesses. It can be argued that achieving personal goals is therefore the reason why entrepreneurs are prepared to accept a high-risk environment. A high propensity for risk-taking is therefore an entrepreneurial trait (Gilmore, Carson & O'Donnell, 2004:350).

With the formation of a new venture, entrepreneurs usually rely firstly on their own financial contribution, sacrificing earnings and non-fiscal benefits. Kerins, Smith and Smith (2004:387) argue that an entrepreneur must commit significantly to financial, human capital and opportunity costs. Kerins *et al.* (2004:403), conclude that entrepreneurs have a much higher opportunity cost of capital than well-diversified investors. Role players operating in the risk environment are entrepreneurs, financiers, lawyers, suppliers and customers, who dictate financial, operational and strategic planning.

It is within the borders of this environment that entrepreneurs develop personal goals, create new ventures and operate their businesses. Entrepreneurs meet the challenge to make decisions under 'calculated' risk scenarios and adopt a leadership role in the process. Simons (1999:85) argues that the pressure to achieve challenging goals can stimulate entrepreneurial creativity and innovation that lead to superior financial performance. The deduction is then that the focus point of entrepreneurial behaviour is the aspect of risk and leadership. Entrepreneurs will obviously approach risk in different ways. According to Dollinger (2003:7), entrepreneurship exists under conditions of risk and uncertainty. Wickham (2004:196) holds the opinion that entrepreneurs make decisions under conditions of ambiguity rather than risk, while Everett and Watson (1998:371) distinguish between the economy-based risks, industry-based risks and business-based risks unique to the business.

Changes in the first two risks, over which the entrepreneur has little or no control, are usually dealt with under risk contingency plans. In dealing with business-based risks, entrepreneurs react to distress in their business in different ways. Orme (2002:26) opines that some entrepreneurs will withdraw from business activities, some will enter a phase of denial and some will immediately accept the unique circumstances.

Richardson, Nwankwo and Richardson (1994:14) conclude that success and arrogance are closely related to entrepreneurs failing. Koellinger, Minniti and Schade (2007:512) researched the entrepreneurial overconfidence that leads to entrepreneurs perceiving themselves as skilled, able and opportunistic in identifying business opportunities. Unsuccessful entrepreneurs will go through various stages, firstly one of denial (Francis & Desai, 2005:1203), and then finally acceptance. Owing to the very characteristics of entrepreneurs, which among others, include perseverance and goal achievement, entrepreneurs will try to continue with business activities under conditions of distress. Simons (1999:87) warns that the pressures (self-inflicted owing to fear of failure) to achieve challenging goals can bring unintended risks. Entrepreneurs take calculated risks throughout the various stages of the entrepreneurial process.

Van Vuuren (2005) describes the entrepreneurial process as consisting of the pre-start-up phase, start-up and survival phase, which is 0 to 3 years, early growth 4 to 10 years, and the maturity phase 10 to 15 years. Finally, the harvest – or stability – phase, 15 to 20 years. The risk propensities can be further categorised into possible entrepreneurial behavioural risk patterns in the various stages of the entrepreneurial cycle:

- Pre-start-up = appetite for risk
- 0–3 years = moderate/calculated risk-taking
- 4–10 years = calculated risk-taking
- 10–15 years = high risk factors, uncalculated risk-taking
- 15–20 years = low risk-taking

Garcia (2006:7) argues that many entrepreneurs are late in recognising that "business-as-usual" practices need to change when their businesses start to deteriorate; accordingly, entrepreneurs' actions usually reflect defensive and aggressive attitudes that are not conducive to the continuation of cordial business relations with their creditors.

In her studies, Gaglio (2004:535) argues that opportunity identification through entrepreneurial cognition and veridical (truthful) interpretation requires a correct perception of the changing situation by the entrepreneur. Veridical interpretation entails that the entrepreneur correctly establish the real causes of change. Gaglio (2004:539) concludes that alert entrepreneurs may respond to change or surprise earlier than non-alert entrepreneurs. The key to repositioning the business is for the entrepreneur to accept that mistakes have been made and to understand where and why these mistakes were made. Garcia (2006:4) argues that an ineffective response to crisis causes a competitive disadvantage. Entrepreneurs need to re-strategise and reorganise the business and maintain growth and profitability.

Orme (2004:26) argues that the entrepreneur goes through various phases of denial, depression, anger and, finally, acceptance. Agreeing with this statement, Altman (1984a:171) suggests that it is more sensible to detect impending failure well ahead in order to be able to take corrective action. In support of Altman's view, Chowdhury and Lang (1993:8) state that, whilst failure is not inevitable, entrepreneurs and/or managers can, through discretionary actions, stop and reverse decline in the business. Lohrke *et al.* (2004) conclude that it is necessary to look beyond financial decline to broader indices that trigger the turnaround process. Unfortunately, at the current juncture, entrepreneurs face various challenges when attempting to turn around their business. These challenges are, but are not limited to, legal, management, financial and/or product constraints. Gopinath (1995a:76) concludes that for banks (and turnaround managers) "strategies are dependent on the perceptions of the causes of the problems".

Seen in the light of the above discussion, there is always risk when entrepreneurs start ventures. Moreover, there is also risk associated with turnaround situations; hence, the proposed verifier determinants will assist in managing that risk.

2.5 QUO VADIS?

Internationally, business turnaround theory is embedded in legislation and a comprehensive body of knowledge is available. The shortage of theory in South Africa highlights the need for research on designing a business turnaround strategy, tailor-made for the South African business environment. Most businesses concentrate on creating innovative plans to ensure growth. A turnaround is concerned mainly with the rescue, reorganisation, restructure and repair of substance, which has malfunctioned in the business process. The administration of a business is perceived to be visible, as management knows exactly what is to be done – whereas a large portion of the turnaround vocation scope is hidden and unknown.

During the normal business process, uncertainties within the operating environment are imposed and dealt with. In a turnaround environment, there is an additional and significant level of uncertainty. As a turnaround progresses, the surfacing of unexpected negative information is considered as a turnaround trap, for example: James (2002:49) reported that he, after commencing with a turnaround, discovered that an important order had been cancelled five months earlier. As the order was about 20% of annual turnover, the result was a horrendously overstocked situation. The extent to which any decline has manifested itself in a business will only emerge after the turnaround practitioner has commenced work. Newly discovered "decay" and "rot" may lead to the failure of the turnaround plan.

This study investigates the management discipline of business turnaround both currently and in the future. Business turnaround is a relatively new concept in the field of South African business management science. Owing to its infancy, there is a huge shortage of appropriate literature locally. Pretorius (2006:2) confirms that there is a small body of knowledge in South Africa, although it is expanding.

Verifier determinants (which will be defined later) are used to confirm the early warning signs that are used extensively to confirm causes, verify the correct sign and substantiate issues to consider when compiling a strategic rescue plan.

The identification of verifier determinants will contribute to the uncovering of other hidden critical issues. This research focuses on the design of turnaround strategies by investigating and improving early warning signs theories. Warning sign verification will be incorporated into the structuring of the turnaround strategy as an action and timing tool. Both investors and creditors (including lenders) have a vested interest in the early detection of financial distress. This is confirmed by Aziz and Dar (2004:25), who reinforce the need for the early detection of financial distress to enable the taking of corrective action in good time.

Using verifier determinants, the turnaround practitioner and/or the entrepreneur will be able to apply the plan effectively as a business rescue tool. For the participating creditor, it may restore credibility and validity in the mechanics and rationale of business plan construction. Once credibility and validity of planning has been restored, the use of the plan as an effective preventative (counter failure) management tool can be reintroduced. With the concept of "verifier determinants" built into the early warning diagnostic structure, the entrepreneur and turnaround practitioner alike will be able to take corrective measures in time to prevent default and/or further deterioration of the business.

2.6 TURNAROUND IN SOUTH AFRICA – STATUS QUO

Turnaround in South Africa, as an industry and as a business science, is still in an early development phase. Although various informal turnarounds were, and still are, contemplated, formal turnarounds (protected by law) will only commence from mid-2011 onwards. The South African government is committed to including turnaround in the revisions of the Companies and Insolvency Acts. Leuvennink (2004:4) reports on Minister Brigitte Mabandla, the then Minister of Justice and Constitutional Development, who requested that businesses should rather be rescued (turned around) than liquidated. The Department of Trade and Industry, in its Guidelines to Corporate Law Reform (2004:42), has clearly indicated the government's concerns regarding the winding up of companies. Statistics South Africa (2009:8) reports in their February 2010 release that the number of civil cases (summonses) for debt in South Africa increased from 254 426 in 2008 to 293 710 in 2009.

This substantial increase of 15,4% clearly demonstrates the need for corporate reform. The South African government is also committed to enforcing corporate governance through the implementation of the recommendations of the King II and III reports. Drew, Kelley and Kendrick (2006:128) argue that strategic risk management is not restricted to improvements in existing governance and ethics, but includes those risks that threaten the long-term success and survival of a business.

The government's promise to change legislation is now manifested in Chapter 6 of the new Companies Act, which will allow and regulate turnaround practices once implemented during the course of 2011. In terms of Section 128(2) of the 2008 Companies Act, the government may appoint a person or body (association) to regulate the practice of persons as practitioners. The recently established Turnaround Managers Association of Southern Africa (TMA [SA]), operating under licence to TMA International in cooperation with the Association of Business Administrators of South Africa (ABASA), is currently applying to government to take up this regulatory role. Currently, neither facilities nor academic syllabi for postgraduate accreditation for professional turnaround practitioners exist in South Africa.

The need to introduce some minimum academically accredited qualification standards for turnaround practitioners operating in the South African business environment is now being addressed by the TMA (SA). TMA International, the international body for the accreditation of turnaround practitioners is housed at the University of Chicago, in the United States of America. The main shortcoming of this from a South African perspective is that US legislation; insolvency, tax and corporate law are paramount in the syllabus of this three-year course. Various turnaround courses are presented by most of the tertiary institutions in South Africa, for example the ComTURN (South Africa) programme presented by the University of Pretoria under the auspices of the Chair in Entrepreneurship. There is a dire need to accommodate South African rescue legislation and business turnaround culture in the accreditation of existing and future South African turnaround practitioners as being able to construct a turnaround plan is instrumental in fulfilling the requirements of the new South African legislation.

It is the aim of this research to create a framework to equip entrepreneurs and turnaround practitioners with adequate background knowledge to add to the current body of knowledge and effectively create/use a turnaround plan. Any school that proposes to undertake the accreditation of turnaround practitioners will be equipped with formal guidelines to compile an acceptable, valid and reliable business turnaround plan and incorporate it as such into the proposed syllabus. Current formal turnaround routes (ss 311 and 427 of the old Companies Act) are, owing to various negativities and high costs, not desirable and entrepreneurs still favour a more informal approach. Hence, there is a multitude of dangers and constraints (acts of insolvency s 8 of the Insolvency Act, Act 24 of 1936) that impact negatively on a possible successful turnaround.

2.7 CONCLUSION

The successful running of a business is just a small part of the challenges facing entrepreneurs. The psychological impact on the entrepreneur when facing decline, distress and then turnaround should not be underestimated. It is therefore essential that entrepreneurs are equipped with extensive, integrated and applied knowledge of early warning signs that will enable them to spot the danger signs. Accordingly, they need to be equipped to formulate and implement rescue plans for saving their businesses. In conclusion, the deduction is that entrepreneurs demonstrate behavioural patterns of high-risk acceptance. The chapter has identified and addressed the need for an early warning control system in businesses.