WARNING SIGNS OF BUSINESS FAILURE

There is ample statistical evidence to show that 30% of all failures occur within the first 5 years of the life of a business.

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There can be any number of symptoms of business failure; however, there are underlying and common indicators which show up at various stages. Indicators of failure, which should be interpreted by the owner as a warning, are:

- significant reduction in turnover,
- substantial increase in costs,
- lack of profitability.

An owner who takes no notice of these warnings may eventually be unable to meet financial commitments within an acceptable time frame. In this situation the effect may be that:

- financial pressure being applied by creditors and financiers of the

business,

- legal proceedings being taken against the company,
- receivership,
- bankruptcy or liquidation.

There are three critical stages in the declining fortunes of a business and its loss of profitability. If appropriate action is taken at these stages there is every chance of a business turn around and a return to stability and solvency

The stages are:

First stage. The business is sustaining losses, is close to insolvency and the WARNING SIGNS are there. Maybe the application or reintroduction of disciplined management practices would suffice.

Second stage, The business is insolvent but the application of informal "workouts" are appropriate.

Third stage. The business is insolvent and the work out as in the second

stage would not be appropriate. It will be necessary to appoint an Administrator for a formal (statute regulated) who can apply statutory recovery techniques,

In all the above stages the following must be given first consideration:

- Action oriented management.
- Effective financial controls and management information systems.
- A simple organisational structure.
- A clear product focus with a deliberate concentration on what the firm does best.
- Regular reviews of strategy.
- Review staff morale.
- Focus on the customer.

WHERE DO YOU START WHEN THE BUSINESS GETS INTO TROUBLE?

All business reconstruction proposals require a review the current financial position of the troubled business and/or its businesses and review the future viability. The investigation may be initiated at the request of a company and/or its members, or the company's secured and unsecured creditors. However, in most cases the investigation is requested by the secured lenders with the approval of the company directors.

The independent appraisal of the company's current financial position and future viability will usually place particular emphasis on recommended asset and/or debt restructuring proposals to preserve the business as a going concern and hopefully improve the position now or in the future for lenders and the company itself.

The circumstances surrounding the need for the review will vary in each case; however, the key areas which will be reviewed will usually be the following:

Cash Flow

Commonly, the major problem facing companies experiencing temporary insolvency is the negative cash flow. One must consider the

options available to preserve and create cash flow. Prepare profit and loss projections for the business and cash flow forecasts and based on these projections, determine the size and extent of the cash flow requirements.

Prepare the cash flow on monthly rests for a minimum period of 12 months together with a weekly cash flow for a period of, say the first two months to demonstrate the immediate funding requirements.

Aspects requiring consideration in the preparation of the cash flow will include:

a) Existing stock levels and the existence of obsolete and/or slow-moving stock

b) Debtor levels, age and likely recovery

c) Trade and other creditor arrears, including all taxes, rental on property; leased assets, interest on debt facilities and unpaid insurance premiums

d) Possible proceeds from the sale of non-core assets

e) Capital expenditure requirements

f) Existing debt facilities, i.e. servicing and repayment

Review of Asset Structures

Analyse existing asset usage including the turnover of stock, the number of days in debtors and surplus fixed assets including superseded plant and equipment. This review will assist you to understand the business including its working capital requirements.

A common problem encountered when reviewing asset structures is that where the company is locked into existing lease agreements on land and/or buildings which exceed the company's requirements. This is particularly evident where the business has been through a period of substantial growth and now in the ensuing downsizing exercise it is not possible to automatically reduce the fixed costs associated with the premises. Early termination clauses make it prohibitively expensive to renegotiate and/or relocate.

When reviewing the asset structure, it is necessary to conduct the review in conjunction with a thorough review of the company's products, its various markets, its people technical know-how and other resources available to the business.

Viability Indicators

1. Business and Risk Assessment Analysis

When preparing the company's statement of financial position, valuable knowledge will be obtained which will provide an insight into the reasons for the company's existing liquidity crisis and/or indicate problems it is likely to encounter.

It is necessary for the parties involved in a workout to carefully consider the business and its associated risks. The investigative accountant will initially review the company's core business and understand aspects which influence the business. These may include climatic circumstances, seasonal patterns, domestic and export markets, technical know-how and intellectual property and rights.

The environment is playing an increasing role within the business community and it cannot be under-estimated when considering consumer trends and demands for environmentally friendly goods and services.

It is necessary to understand the business' competition to assess whether thee is over-capacity. Does the industry need to be rationalised?

If the business is in manufacturing, review the plant's operational efficiency and endeavour to determine with engineering and/or plant supervision staff what are the production limitations and/or bottlenecks. Discussion with management and production employees will also assist an investigative accountant to understand the mood and morale amongst the employees.

Certain industries have a history of industrial unrest including the construction, transport and meat industries. The resolution of industrial unrest may well be a determining factor in assessing the viability of the business.

2. **Operating Indicators**

In order to consider the company's potential and its future viability the following operating indicators should at least be considered.

a) Break-even analysis

b) The projected level of sales and gross margins and sensitivities.

c) Product and customer analysis

d) Comparative analysis across the company's various divisions and/or branches (if these exist) to ascertain the profitable and non-profitable arms of the business.

e) The level of fixed and variable overheads and ascertain the level of scope for "shrinkage" of these costs

f) Management information and whether the information provided is sufficiently timely and accurate to allow informed and accurate decisions to be made.

g) The level of the company's existing order book.

Recommendations and Findings of The Investigation

Following the review undertaken by an investigative accountant the next step is to determine the future course(s) available to the various parties the workout proposals including the responsibilities of the respective parties, time frames to be adhered to, and the development, installation

and monitoring responsibilities pertaining to the plan.

Experience tells us that nine times out of ten workouts will involve at least a return to core operations to achieve a "right size" situation. A workout will also entail disposal or closure of unprofitable divisions or branches, the sale of assets which are not contributing to a positive cash flow and a cut back fixed and variable costs including salaries and wages.

Eliminate inefficiencies and obstructions.

Reconstruction of a company to bring it back to a profitable on- going concern is recommended only if the core business is either profitable or potentially profitable.

However, in circumstances where the company which is failing, has no such core operation, the demand for its goods and services has fallen to a level where no profit is being made and creditors are knocking at the door, it may be time to take action and close it down.

If the company has given a charge over its assets and you are a guarantor, you would rush straight to the bank or your legal adviser, to ensure that the charge gives the bank first priority over the assets of the company. If

the bank has priority, it will be first amongst the creditors to be paid out of the proceeds of the sale of the company's assets. The more money that the bank recovers from the company the less they will be demanding from the guarantors.

Take a very close look at all guarantees and in consultation with your legal adviser consider how they will affect you. The law in relation to guarantees is evolving dramatically. In particular the courts will not allow a guarantee to stand where there has not been fair dealing, i.e. where there has been misrepresentation or misleading or unfair behaviour on the part of the seeking the benefit of the guarantee.

Once satisfied, the company should be placed into liquidation or provisional liquidation as soon as possible, because to trade on whilst insolvent will involve the directors in personal liability to creditors if the company continues to incur debts.

In placing the company into liquidation, the proprietors are advised to co-operate with the liquidator to realise the best price for the sale of the assets or the business as a whole. The proprietor's knowledge of the market values of the company and its assets will be of invaluable assistance to the liquidator. This same co-operation will help to minimise

the costs and expenses of the liquidator. This may become important to the proprietor who has given guarantees to creditors of the company. It is in the interest of the proprietor [guarantor] to see that these creditors receive the largest dividend possible so that he/she will have to pay them as little as possible. It is also important for the proprietor to receive the largest dividend possible if he/she is a creditor of the company.

The law states that if a person is a director of two or more companies which are placed into liquidation and the liquidator pays less than 50¢ in the dollar to the creditors then those person/directors can be disqualified from holding office as a director for 7 years. If the directors in assisting the liquidator help the creditors to receive more than 50¢ in the dollar, they will not be disqualified.

Even if proprietors are not inclined to assist the liquidator they should be aware that they are under a statutory obligation to do so.

Finally, if the failure of the company impacts upon the proprietors/directors to the point where they themselves are insolvent, usually because of liabilities under guarantees, they must consider whether they should enter into an arrangement under Part 10 of the Bankruptcy Act or some informal arrangement with their creditors.