



BUSINESS FAILURE – WARNING SIGNS

Why Businesses Fail

What happens when a business fails, in simple terms, is that it is unable to pay bills when they fall due. Businesses can run out of cash due to :-

- Lack of profit – the available cash has been drained away by losses.
- Excess illiquid assets – the business has tied up too much of its cash in plant and machinery or the development of a new product and thus has insufficient left to fund its trading.
- Too much growth – the business's transactions are expanding far too fast.

The Types of Business Failure

Business failures generally fall into one of three classic types.

1. The Start up That Never Starts

Statistics show that the majority of businesses cease trading within 12 months. Some of the commonest causes of such failures include the following:-

- **The business model is wrong:** the anticipated market does not exist
- **The business is under-capitalised:** it runs out of cash
- **The business survives the former** but hasn't become sufficiently established and fails to weather a downturn a longer-established business would survive.
- **The business has been set up in a high-growth industry** - but fails to survive the 'shake-out'. This is a common phenomenon in new or suddenly fashionable sectors. In such situations many new players enter an expanding market to cash in on the perceived easy profits only to find that the sector's initial growth slows or even reverses, leaving the rush of entrants with overcapacity and facing a slower or falling demand. How many mobile phone shops are there in your high street today? How many do you think there will be in five years time?
- **The business person has the wrong:** personality, type or lacks the determination to see things through. For example, he or she is unwilling to face up to necessary business tasks, such as cold calling for sales.

2. The Catastrophic Failure

These types of business failure are surprisingly rare. Such failures are where the business fails to survive some traumatic event, such as those listed below. The effects of each type of event can, in most cases, be significantly reduced by good management:-

- A major fire or flood may be regarded as an uncontrollable 'act of God' but businesses should take some steps to plan for such eventualities by way of insurance cover and sensible contingency planning.
- Major fraud can be catastrophic. Therefore the management of any business should take responsibility for setting up controls to ensure this does not happen. Many frauds start in a small way and grow hugely over time.
- Occasionally, a governmental act can be catastrophic since legislative changes can prevent businesses from operating almost overnight. More often, however, legislation changes the rules by which businesses have to operate. For example, in the 1990's the UK government changed the rules about payment made by local authorities to nursing home services. While such changes can be quite swift, the nature of the political process usually allows some warning. It is also true to say that, in the example just given, not all nursing homes were forced out of business and that it was the good quality, well managed and well run nursing homes that were best positioned to survive the changes in legislation.
- Major litigation, for example, over an alleged patent infringement, can also sink a company. However, it's up to the management to have the foresight to deal with this sort of commercial risk.

Overtrading failures, particularly in high growth companies, may often feel like catastrophic failures since they may seem to appear quite suddenly. However, in retrospect the symptoms of increasing cash pressures, are often there if you look.

3. **Incremental Failure over time** - Incremental failure over time is the 'normal' type of failure for an established business.

The Symptoms of Normal Failure

Underperformance:-

- Your market share is being lost
- Your turnover is stagnant or reducing
- Your profits are stagnant or declining and, sooner or later, the first losses are being reported
- The bank is taking security for its lending (if it doesn't already have it) and is starting to demand more information from you.

Distress:-

When your business is in distress, the following situations may arise.

Firstly, you may find that your staff turnover is rising, and your business needs to borrow heavily to fund trading (as a result of its reduced profits). Increased borrowing can lead to the following:-

- Your bank overdraft rises. The bank sees a growing 'hardcore' of overdraft debt.
- You start to stretch creditor payment terms as you start to rely more and more on creditor funding. This results in 'higher' creditors and the aged creditor reports begin to show significant older values.

- You are forced to acquire assets on lease or hire purchase you would once have brought outright.
- Despite your dislike of it (because it's only something businesses in difficulty do) you start to think about moving to factoring or invoice discounting as a way of getting more lending against your debtors than your bank is giving you (or you may have no choice if your bank insists).

Secondly, you start to make regular or more severe losses until losses become the 'norm'. You seem to have forgotten you are in business to make a profit and you consider breaking even to be 'good news'. Your credit rating starts to fall and your reported financial performance worsens and your accounts start to appear later and later. Your audit report is qualified. Next your relationship with your bank becomes strained as they start to require regular meetings, more information and projections and further personal guarantees and / or the introduction of an investigating accountant.

Finally, you gamble. You put a disproportionate effort into long-shot big projects that will save your business if they come off rather than facing up to the here-and-now unpleasant actions you really need to take.

Crisis

When your business is in crisis, your finance director jumps ship or goes off on long-term sickness. Your overdraft is at or over the limit and your bank is bouncing cheques (or threatening to do so) and pressing for a reduction in its exposure. You are making 'payments on account' and/or actively delaying payments to creditors in an attempt to manage the cash or to stave off failure. Suppliers are demanding payments to clear or reduce their accounts and are placing you on 'stop'. Your statutory payments (PAYE,VAT) are in arrears.

Legal action begins, starting with writs, county court judgements, statutory demands for payment, and threats of petitions for winding up your business. The legal pressure increases, with HMS Customs & Revenue sending in the bailiffs to take walking possession over your assets. Winding-up petitions are presented and letters from Insolvency Practitioners (IPs) and Debt Councillors arrive asking if they can help.

IP's eager for a job, notify your bank you are in trouble, basing their judgement on the legal actions that are being taken against you (which becomes a self-fulfilling prophecy). Your landlord distrains for unpaid rent.

Credit Scores

Credit-rating agencies earn some of their income through checking on the health of businesses so as to be able to advise other businesses on the levels of credit to extend. Widely available from a number of sources, these assessments will show you how independent external agencies have assessed your business's financial health on the basis of your published accounts (e.g. some are on the basis of a score from 1-100). They can also be used to provide a snapshot of current, apparent financial health as well as of annual trends.

Take An 'A' Score Test

An A score test uses non-financial signs in a structured way. It makes the assumption that business difficulties stem from problems with management organisations, controls, or the ability to change, which over time, can in turn lead to real signs and symptoms of difficulty. To undertake this test, simply look through the statements set out below. If you disagree with a statement, cross out the relevant score. If you agree with it, leave the score as it is. Make each a positive 'yes' or 'no': There are no part marks.

Management	
The business is run by an autocrat	8
The chief executive and chairperson are the same individual	4
The other directors are non-existent, passive or non-contributing.	2
Your business lacks directors with all-round skills.	2
There is a specific lack of a strong finance director.	2
Your business lacks management depth below board level.	1
	19
Accounting controls	
There is no budgetary control, budgets or variances reports	3
There are no up-to-date cashflow plans and no or poor knowledge of borrowing requirements.	3
Your business has no costing system so that managers do not have accurate information about costs/contributions.	3
	9
Ability to Change	
There is a failure to notice/respond to change in the business environment. (Signs include old-fashioned products an antiquated factory, ageing directors or no computers)	15
Specific Risks	
The business has relatively high levels of borrowings	15
The company is over-trading (the company is expanding faster than it's funding)	15
The company is exposed to a big project (where the company is at risk of collapse if failure occurs).	15
	45
Warning Signs	
There are real signs of financial difficulty (poor accounting ratios for sector, poor credit rating).	4
Your business employs creative accounting to disguise the difficulties.	4
There are non-financial signs of difficulty (capital expenditure, decisions delayed, staff turnover rising, officers on need of repair/renovation).	3
There are terminal signs (the bank is reducing its overdraft facility, creditor pressures).	1
	12
Total possible score	100

