Asia Times

The Warning Signs of Insolvency

The vast Majority of recent media coverage on Insolvency has tended to concentrate on the spectacular collapses of Leemans and Merrill Lynch. There appears to be little focus on the majority of smaller business which have failed and the reasons why these business have failed. Often the final demise was predictable several months ahead.

Using basic financial data and business awareness it is possible to determine when companies will be in severe difficulties. Awareness of the various factors which can lead to Insolvency is a first step to preventing it.

The Insolvency Act 1986

The Insolvency Act 1986, defined Insolvency as when a company is deemed to be unable to pay its debts, If it has been proven to the satisfaction of the court that the value of the company's assets are less than the amounts of its liabilities.

Hence, at its simplest if a creditor to whom the company owes a sum exceeding £750, has produced a written demand requiring the company to pay the sum due, and the company cannot or is unable to give any undertaking to do so within three weeks, the court will then allow the company to be wound up.

Liquidity

There are a large number of companies which have been built up, which although fairy profitable, fail because they run out of cash. This can arise if a company has grown rapidly and there has been a resulting increase in stock and debtors, but insufficient effort has been concentrated on realising the debtors into cash. Hence a company may be making sales, but failing to have those sales "banked" in terms of cash, it will eventually face a liquidity crises.

Although, Liquidity is the main short term priority, over the long run, there is a close relationship between the level of profits earned and amounts of cash generated. A company will get into financial difficulties once its poor trading performance leads to inadequate profits and eventually to inadequate cash.

Corporate Insolvency

Corporate Insolvency can be grouped into three main types. Firstly and despite receiving the least media attention are the small companies which have been established fairly recently. Secondly, there are those companies which rise rapidly before crashing and lastly there are those companies which are publicly owned and appear to have substantial management teams. These companies have failed to appreciate the long term erosion of their markets or mark-ups etc. An example, can be seen in America with Ford Motors, who have after years of neglect is now attempting to reconstruct the corporation by closing plants and making a record number of workers redundant.

A Builder's Dilemma

These series of articles will concentrate on the smaller companies, which the majority of businesses are. Up to two thirds of business failures occurring in these companies happen within three years of foundation, this figure is rapidly increasing due to those entrepreneurs who entered into business at the height of the business boom in the past eight years with enormous optimism, but inadequate financial awareness.

Many of these entrepreneurs lacked the basic financial skills. An example of this can be found in the case of a sub-contractor working in the building industry in Birmingham. Regrettably he decided to develop his own site, not fully appreciating the long time delay between building and selling the individual houses built, the company soon ran into liquidity problems.

The success or lack of it, in a new business will often be determined by the initial motivation of the entrepreneur. It has been found that unemployed people who set up in business in order to find employment are more likely to fail than those who were already employed, but have set up in business, in order achieve their independence and success.

the expense of marketing.

An example, of the way marketing can improve profits can be seen at its simplest, in the case of a shop keeper who can start by determining the relative mark-up on his products and strategically placing the products with the highest mark-up, on those shelves his customers are more likely to see. Successful business have always been those that are run by management willing to take the time and effort to prepare strategic plans, both on a short and long term basis. The secret of success in the recent cash starved times, is to a tight control and monitoring over the businesses cash resources by the implementation of stringent debt collection procedures and have a thorough ongoing view of its cost structure.

Limit Your Exposure

Late Payment

Late payment is draining the small business sector and making it too weak to lead any recovery. It is a far too common for companies, particularly the large ones, including many PLCs to pay their invoices six months or more after they are due. The sooner these companies sign up for the Confederation of British Industry's Prompt Payers Code the quicker a recovery can begin

Support of this code is one area where the government needs to make a difference by legislation, if necessary in order to provide some assistance to the small business sector. This is particularly so at a time when the small family owned business can ill afford to lose the custom of their larger clients; by enforcing a more stringent collection policy which they may need to, as they are being hampered by the banks increasingly new found reluctance to fund any short-term cash flow difficulties.

But the Plcs are not the only problem; businesses in the UK are on average waiting 80 days and more for their debts to be paid. The cost of offering this credit to debtors can be expensive not only in terms of the costs of financing these sales with what is likely to be an overdraft, but also the other costs involved, such as the extra administration required to monitor an overburdening sales ledger and the increasing possibility of bad debts, as the age of the debt increases. All of this can cost up to 10 per cent of turnover.

Hence every business requires more than ever the operation of a proper credit control policy, which must first start with the individual who is making the sale. The salespeople have to be the eyes and ears of the business and should be able to advise not only on the debtor's ability to pay, but also whether it is prudent to give additional credit. Clearly bonuses/ commission have to be paid on cash received from debtors and not sales invoiced. A second source of information are credit status reports, these reports can nowadays provide a wide variety of information. For instance, whether the directors have been disqualified or bankrupt, details of mortgages and County Court Judgements, as well as the company's annual accounts and financial ratios.

These ratios can be useful as they indicate the normal length of time before a business pays its debts. Constant monitoring of debtors is required not only of new customers but also your established ones. One computer stationery supplier in the Midlands is finding that customers that it has been trading with for over ten years are now going under.

Credit Control

The second stage in limiting bad debts and getting debtors to pay early is to implement and monitor a proper credit control policy. This requires not only a regular review of the aged debtors analysis, but also a standardised approach to the collection program, which must include invoices, statements, follow-up letters and telephone calls. Calls made on a regular basis are the most effective method of realising debtors, as those who shout loudest get paid first. Finally a plan of action must be ready to be implemented if these procedures do not produce the results.

If your own internal debt collection efforts are exhausted, it may be productive to place unpaid debts into the hands of a debt collection agency. This can be considerably cheaper than the cost of the initial stages of the legal process, particularly as most agencies work on a commissions basis. One intriguing new idea to take before the legal process is the use of a debt collection agency's own standard letter threatening legal action which can be sent by the accounts staff. These letters can be purchased from some collection agencies for a standard yearly charge of between £300 - £400 and can save time and money prior to taking the legal process.

The Recession

Even if a business has survived its initial faltering steps the recession will take its toll, because as a small business it has inadequate resources to survive a significant downturn in its trade. It is also limited due to its own management limitations, who may have inadequate experience of preventive actions. As trouble strikes, the small entrepreneur has little idea of what steps to take or who to turn to. But the disadvantages of size is also one of the entrepreneurs strength in that due to its size, the small business has greater flexibility and is free from the complexities of the larger company. In addition, proprietors of small businesses will have greater determination to survive than the managers of large companies, due to the financial stakes and personal efforts already invested.

Causes of Insolvency

For the business to survive it must first identify the potential causes of insolvency. The next article will detail a summary of the principal factors and the necessary action to take, once a principal factor has been determined.

Planning For Success
lthough the causes of corporate failure are many and various, knowledge of the primary causes is essential, in order to identify any problems and therefore take the necessary actions. Historically poor management has always been the main cause, but the extent of the recent slowdown has meant that external environmental factors are becoming increasingly important. One of those companies which fail principally due to poor management, four separate factors can be identified:

1)Insufficient management depth;
2)A poor finance function;
3)An overbearing managing director / chairperson
4)An uninvolved work force.

In order to create an involved work force it is important that all employees know the goals of organisation and are sufficiently motivated.

The Demise of IBM

A consequence of weak management is the poor planning and decision making which arises. Planning has to be done in advance in order to prevent day to day problems becoming crises, which will inevitably lead to management becoming involved in fire fighting and possibly wrong decisions as well.

An example of poor planning could have been seen in America, when IBM reported a world record annual trading loss of $4 billion. Having failed to appreciate the changing market in main frame computers, they found that only a massive reconstruction could be enough to save this truly mammoth corporation found.

Planning is essential regardless of the size of the company. One factor to determine is to assess the environment in which the business operates and therefore determine the external factors which will have a bearing on its performance. These factors should then be monitored in order to take preventative action at an early stage. Management should also start by determining the principal objectives of the business. Once these have been determined a strategic plan needs to be evolved, incorporating these objectives, bearing in mind, the resources available and the external environment.

The strategic plan can then be devised into a plan of action with short and long term aims. Another consequence of weak management tends to be inadequate financial control. This leads to a lack of financial information which means that management is unable to determine its present success or lack of it nor indeed plan its resources for the future. Financial control should not solely evolve around the preparation of annual accounts, which although important for long term planning, do not allow for the day to day monitoring of a business health.

A more appropriate method of assessing a business's well being is the preparation of monthly budgets which allow a company to set medium term targets and assess its performance against these targets.

Throwing money away

The preparation of cash flows will enable a business to plan its future borrowing requirements. A cashflow should be prepared by every business, regardless of its size. An example, can be seen with a case of a small confectionery shop in Birmingham which recently incurred a banking charge of £45 on a cheque of £50 made payable to a supplier. A simple cashflow would have prevented this cheque from being dishonoured. Hence proper monitoring will not only save money, but also embarrassment.

Finally a crucial error made by businesses is to fail to understand and appreciate their own markets. They may become product oriented and hence concentrate on production or distribution at the expense of marketing.