Fédération des
Experts Comptables
Européens

AVOIDING
BUSINESS FAILURE
A Guide for SMEs

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EXECUTIVE SUMMARY

In the first few years of this century we have seen a series of major corporate collapses, which have had far-reaching consequences for the whole business community. Several of these collapses have occurred in the US, but others, most notably Parmalat, have proved that Europe is not immune from large-scale financial disasters.

The purpose of this paper is to:

- Examine the most common internal and external causes of business failure for Small and Medium Sized Enterprises (SMEs [1]);
- Look at the effects of failure for the business and its stakeholders;
- Provide practical guidance to entrepreneurs of SMEs by analysing the most appropriate preventive measures to avoid business failure; and
- Be of interest to the advisors of SMEs, especially those who do not specialise in business failure and recovery.

Key Recommendations of this Paper

External Advice

SMEs should seek advice from experts in good time in order to be trained to acquire the appropriate skills for detecting and reacting in advance to threats to the survival of the business. Professionally qualified accountants play a significant role in this respect, as they have the knowledge and expertise to advise and help entrepreneurs through all stages of an SME's life, enabling them to be prepared to spot and react to any warning signs of potential insolvency.

Planning, Budgeting and Forecasting

SMEs should put in place systems of planning, budgeting and forecasting which enable them to identify key performance indicators and which incorporate provision for them to compare, on an on-going basis, actual performance data with the original forecasts and targets.

[1] In the paper SMEs are defined according Headcount thresholds set up by Commission Recommendation 280/1996:

- Medium-sized enterprises: <250
- Small enterprises: < 50
- Micro enterprises: <10

On 8 May 2003 the Commission adopted a new definition, which will come into force as of 1 January 2005, which leaves headcount thresholds unchanged but modifies thresholds of turnover and total Balance Sheet, as follows:

- Medium-sized enterprises: headcount <250, turnover Eur 50 million, or total Balance Sheet = Eur 43 million
- Small enterprises: headcount <50, turnover Eur 10 million, or total Balance Sheet Eur 10 million;
- Micro enterprises: headcount <10, turnover Eur 2 million, or total Balance Sheet Eur 2 million.

Audit

It is advisable also for those companies for which audit is not compulsory by national law to commission a voluntary audit of their financial statements. This will enhance the credibility of the company's financial reporting and results, especially from the perspective of banks, and will help to identify and deter fraud.

Cash Flow Statements and Ratios

SMEs, like all other businesses, should monitor their cash flows carefully, with the aim of ensuring that they are at all times able to pay their debts as they fall due. On a pro-active basis, businesses should plan for all anticipated inflows and outflows of cash during the planning period. This should be followed up by the regular monitoring of actual receipts and payments and their comparison with the budgeted figures. On a retrospective basis, businesses may find it helpful to compile statements of cash flows over the whole accounting period under review; this will give them a good idea of their actual ability to generate cash and of the timing and regularity of those cash flows.

Entrepreneurs should make positive use of ratio techniques to interpret their accounting information and to identify trends in the financial health of their business. Ratio analysis enable entrepreneurs to asses the performance of their business over time and also to compare their performance to that of others in the same line of business or of a similar size. These techniques will separately be used by third parties, such as lenders of finance, to analyse the underlying health of the business.

Procedures and Management of Risk

SMEs should set up internal control and risk management systems which are appropriate to their size and organisational complexity. Such systems should be sufficient to allow managers to identify in good time any threats to the survival of the business.

INTRODUCTION

When any company fails, its 'stakeholders' – its investors, employees, suppliers and customers – stand to lose out financially. Investors will usually lose the money they put into the business and unpaid creditors will often have to write off their debts. Even the biggest company is likely to have among its stakeholders small private shareholders and SMEs which trade with it. Therefore, the failure of a large company may well lead, indirectly, to financial problems or even insolvency for individuals and businesses that have a financial stake in it. At the same time, it is quite possible for the solvency of an SME to be threatened by the collapse of an SME with which it trades.

Although the failure of an individual SME will never attract the media attention which follows the collapse of an Enron or a Parmalat, the consequences of the failure of smaller companies are certainly a serious matter for those stakeholders who are directly involved. The collective consequences of SME business failure are also a serious matter for national economies: 99 % of all businesses in the European Economic Area are SMEs and two thirds of the workforce is employed in SMEs[2]. The adoption by SMEs of reasonable measures to guard against threats to their business viability is, therefore, very much in the interests of SMEs themselves, their stakeholders and the EU economy as a whole.

It has been widely recognised that business growth and survival depends both on external and internal factors. While most of the challenges which a business will face may be foreseeable, some will be completely unpredictable. However, if a business is to succeed, its management must be alert to all matters which are likely to have a material impact on its viability and must then demonstrate skills both in exploiting opportunities and mitigating threats.

SMEs are, in some respects, more vulnerable to business pressures and generally tend to take more risks than larger companies. They also are less likely to have highly developed internal organisational structures, employing qualified accountants amongst their employees and sophisticated in-house procedures to manage internal control and to monitor business performance and cash flow. SMEs are usually managed by the entrepreneur or, in the case of middle-sized structures, by management employed by the entrepreneur.

It is generally accepted that the biggest obstacle to saving viable businesses is getting the entrepreneurs to take expert advice in good time. Prevention is always better than the cure, and it is always far easier to put out a fire when the first wisps of smoke appear than when the building has become engulfed in flames.

The purpose of this paper is to offer guidance to entrepreneurs and managers of SMEs on the sorts of issues which they should be alert to in the context of responsible financial management. It also offers advice on the actions which they should consider taking where they identify short-term or long-term threats to the viability of their business. The paper begins by examining the most common internal and external causes of business failure for SMEs and looks at the effects of failure for the business and its stakeholders. It then provides practical guidance to entrepreneurs of SMEs by analysing the most appropriate preventive measures to avoid business failure.

FEE has prepared *'Avoiding Business Failure- a guide for SMEs'* with help of its SME/SMP Working Party, which champions the role of the accountancy profession in supporting SMEs across the European Union.

[2] Source: 2002 Observatory of European SMEs

1 CAUSES OF BUSINESS FAILURE

The causes of business failure are many and varied and may stem both from the external environment and from factors internal to the business. Internal causes of business failure may in many cases be capable of being foreseen in advance, while on the other hand some external causes are not so predictable. In most cases, a complex mixture of causes contribute to business failure; it is very rare for one single factor to be involved.

With respect to SMEs, the following internal and external threats to their survival and growth have been identified.

1.1 Internal Causes of Business Failure

By definition, problems that are 'internal' to a business are more likely to be predictable than matters which are external to the business and over which the latter may have no control. Accordingly, 'internal' threats to the viability of a business are more capable of being anticipated and planned for than threats from outside.

1.1.1 Poor Management

The most commonly occurring 'internal' factor in business failure among SMEs is poor management. Even other internal causes of business failure are often inevitably linked to poor management. This term is used here in a broad sense to refer to the failure of the management of an SME to be able to ensure that problems are identified promptly and the correct solutions applied, so as to give the company the best possible chance of survival and growth.

Management competence is clearly an issue for businesses of all sizes, since it is management which is invariably responsible for making all the important commercial decisions in the company. However, the smaller the business, the less likely it is that a company will have, in-house, the specialist financial skills and experience which are vital for ensuring that the decisions made are ones which will best serve the company's financial interests.

Most small businesses are established by one entrepreneur, or a small group of them, who have what they believe is a good idea for creating a specific product or providing a particular service. They will usually have skills and experience in the area of activity for which the new business is formed.

But however good their products and services may be, many SME entrepreneurs do not always have skills and experience in areas such as business planning financial reporting, marketing, customer relations and financial management. Managing a successful SME requires not only good creative and operational skills but good business skills too. Many SMEs do not appreciate until it is too late that, if they do not have these skills in-house, then the success of their business may well depend on them importing those skills from specialist advisors from outside the company or quickly developing basic business skills themselves.

Start-ups businesses are inherently more risky than more established businesses. The first three years of the life of a new business are usually particularly difficult, and a high proportion of new businesses fails during that period. The risk stems from the fact that the business has to prove itself quickly - to customers and suppliers, providers of finance, employees and possibly outside investors too.

In order to get through this difficult initial period, a new business will need to make sure that it prepares an accurate business plan. Any lack of a track record of commercial viability of the business will mean that any prospective commercial lender will look upon it with some caution, and will invariably attach stringent conditions to any loans which it is prepared to advance.

In the case of micro and small enterprises (with headcount below 50 employees), the risk of insolvency rises significantly when the entrepreneur has insufficient technical and practical expertise to monitor the financial performance of the business alone, or simply has not enough time to do so. He might also be unwilling to delegate, either to competent employees or external financial accountants or advisors.

In the case of medium-sized enterprises (with headcount between 50 and 250 employees), the organizational structure is more complex and the company is not necessarily managed by the entrepreneur. The company is at risk when management does not possess the appropriate knowledge and either do not recognise this lack of expertise or are not willing to ask for advice, for example for fear of losing their jobs.

In both cases if management is not able to identify problems and threats when they occur, they will not be able to face up to them and to consider the possible remedial actions which they could take; if it does not face up to these issues promptly, it risks being overwhelmed by them. The ultimate result of poor management is that the company is not efficiently or effectively managed. The SME cannot afford to let such a situation to continue.

Case Study

Poor Management

K Ltd, a UK company, was a long-established, family-owned retail business which at one time had twenty shops in all the main towns of its region. The shop specialized in ‘extra large’ size clothing for both men and women.

The company rarely had an overdraft and depended for its capital on substantial loans made to the company by the entrepreneurs.

Over a period of several years, the company’s performance deteriorated and its profits dwindled. The management failed to consider the underlying reasons for the decline in performance and took no decisive steps to try to win back the business which it was steadily losing. Given that the core business of this company was of a specialist nature, for which it might be assumed there would remain a steady consumer demand, the management should have been prepared to investigate the reasons why customers were taking their business elsewhere and taken some form of appropriate remedial action.

The management’s only real response to the decline in the company’s sales and turnover was to consolidate its resources by closing shops, which it did until, towards the end of its life, only three of the former twenty shops were left.

The company had no active strategy to address its problems. There was effectively no management structure, no focus on the future, no succession planning and no interest in re-training or re-positioning the business. After a long and steady decline, the company went into liquidation.

The entrepreneurs of this company showed no ability to analyze the changes which were taking place in the external environment and to adapt to them. If they had approached an accountant or other experts for advice on their company's position, the accountant might have suggested strategies to market their business better, or to modernise or expand its product range, or to expand the company's capital base. But in this case the owners took no action to respond to its problems with the result that liquidation became inevitable. The business failed not only because the entrepreneurs did not seek advice in good time but also because they were unable or unwilling to draw conclusions from the declining fortunes of their business.

A typical situation in which the entrepreneur might lack managerial skills is the case of succession, when the successors of the entrepreneur who take over the business at his death lack the necessary management skills to manage the business efficiently. The new generation of owners may be totally unprepared or unsuited for its new responsibilities, or just not interested. As a result, a viable business may be sold at a fire sale price to a competitor or may drift from growth to survival to failure[3].

Another common case of bad management is represented by personal extravagance of the entrepreneur, with excessive remuneration and/or personal expenses not related to the business which may lead to business failure, as shown in the following case study.

Case Study

Personal Extravagance

The brothers Heinz and Friedrich Müller each had a 40% interest in the business Müller KG (German limited partnership) and carry personal liability in respect of the business. Their wives each held the remaining 10% stakes with limited liability status and ran a gallery of modern art- without significant commercial success.

The entity specialised in the production of high-grade cutlery. It employed approximately 100 workers and achieved a turnover of approximately 50 million Euros and profits of 2.5 million Euros per year.

Increases in quality requirements together with changes in customer tastes resulted in the necessity for substantial investment in new production processes in the following three years in the region of about 10 million Euros.

Against their accountant's advice, but under pressure from their wives, the personally liable partners decided to withdraw the majority of the profits in order to purchase paintings by contemporary artists. The necessary business investment was delayed for two years and financed entirely by loans.

[3] FEE Publication 'Keeping it in the Family. SME Family Business Succession. Planning for yourself, your business and the next generation' June 2000

As a consequence of the delay in investment, a large part of the customer base turned to the competitors. The fall in turnover resulting from this caused a substantial loss; the interest payments due to the banks could no longer be met. The entity became insolvent, which under German law constitutes a ground for determination of insolvency proceedings under the statutory definition. As in the meantime the purchased paintings fell substantially in value, even an injection of funds by the partners resulting from the sale of the paintings would no longer prevent insolvency.

1.1.2 Deficit in Accounting

Business decisions need to be supported by good quality financial information, which needs to be relevant, user-friendly and available in a timely manner. Poor accounting and reporting and decisions based upon inaccurate or incorrect financial information can actually cause problems which may threaten the solvency of the business.

Where a business operates poor bookkeeping practices which do not comply with recognised accounting principles, it risks incurring penalties from the regulatory authorities. This can apply in many areas, going from general ledger, receivables and payables, to indirect and direct tax (VAT books, VAT returns, other indirect taxes, and income return). In some Member States poor accounting can cause an inspection from fiscal authorities, which can last for a few months and cause considerable burdens on the business, slowing down routine activities.

In addition, poor accounting increases the risk of the business of not being aware of significant problems or of it recognising them too late. Elements such as excessive fixed and variable costs, incorrect revenue recognition, decrease in sales, etc, if not promptly recognised, can lead in the long run to damage to the solvency of the business.

Poor quality or misleading accounting information can result essentially from two factors: either it depends on mistakes of the management or can be driven by tax considerations. In the long-term inappropriate accounting treatment not in accordance with recognised accounting principles (in areas such as depreciation, bad debt, stock, etc) can lead to a decline in business performance.

Poor accounting practices will also, unless corrected, be reflected in the company's statutory financial statements. If the accounting is not in accordance with recognised accounting principles, the financial statements will not give a 'true and fair' view of the financial position of the company, and of the results of its operations and its cash flow'[4]. Where the company is audited, this would cause a 'qualified opinion'[5], a 'disclaimer of opinion'[6] or 'adverse opinion'[7] to be given by the auditors: this would, among other things, prevent the company from obtaining loans from banks.

[4] International Auditing Standards (ISA) 700 – The Auditor's Report on Financial Statements.

[5] 'Qualified opinion' in case of a limitation on the scope of the auditor's work or a disagreement with management regarding the acceptability or application of the accounting policies or adequacy of financial statement disclosures.

[6] 'Disclaimer of opinion' in case the limitation on the scope of the auditor's work is so material and pervasive that the auditor has not been able to obtain sufficient appropriate audit evidence.

[7] 'Adverse opinion' in case the disagreement with management is so material and pervasive that the auditor concludes that a qualification of the report is not adequate to disclose the misleading or incomplete nature of the financial statement.

1.1.3 Poor Cash Flow Management

Poor cash flow management, amongst the most common internal causes of business failure, implies an imbalance between the payment terms taken by debtors and those given to creditors.

The most obvious outcome of defective cash flow management is a significant decline in cash, with the business being unable to cover its repayment obligations, either to banks for loans, or towards suppliers for purchased goods and services. Inadequate management of inventory and Work In Progress (WIP) can also lead to cash flow problems.

The ultimate result of poor cash flow management is lack of working capital to run day-to-day activities.

1.1.4 Inappropriate Sources of Finance

An unbalanced mix of risk capital and loan capital represents a threat to the solvency of the business. An extreme reliance on loan finance can test the company's cash flow position, leading to excessive obligations for the company to repay capital and associated interest, especially when loan conditions allow the lender to vary interest rates.

If the company starts to experience financial difficulties, insufficient risk capital will only worsen the situation, as the existing loan capital may prevent raising further debt finance.

In addition, unsuitable financing options result in an inconsistency between the liquidity of assets and the sources of financing, i.e. financing short-term assets with long-term loans, instead of short-term debt, or borrowing short to invest long. This issue is tackled in detail in the following case study 'Borrowing short to invest long'.

Case Study

Borrow Short to Invest Long

Earth Move Operations Ltd (UK), a family business operating as a company for many years turning over almost 10 million Euros with fifty employees, had made substantial profits withdrawn each year by the family shareholders as dividends, because the company always had the liquidity to enable them to do so.

There was a recession in the earth moving industry which resulted in the loss of a major contract and the price available for the remaining work being dramatically reduced. The company had already enjoyed substantial overdraft facilities that, in line with normal practice, were repayable on demand.

Before the company bankers fully realised that there were difficulties, the Directors had arranged for the company to purchase expensive earth moving equipment amounting to 1,5 million Euros, using the overdraft facility instead of the correct plant finance scheme.

When the company bankers realised that losses were being incurred and the company became short of cash, they immediately asked for repayment. Because of the investment in plant the company could not realise the cash quickly and, as a result, the business was faced with closure. The plant would have to be sold; however, the sales value of the plant was well below its purchase price, which would result in substantial losses and the company would become insolvent.

The Directors consulted an Insolvency Practitioner who was also a Recovery Specialist. After reviewing the company's financial position the Recovery Specialist arranged for the business to be reconstructed by reducing costs to enable it to trade profitably within its market place. He then renegotiated the correct medium to long-term finance secured against the plant to realise funds to satisfy the bankers and ease the cash flow.

The economy picked up and the business once again became profitable.

1.1.5 Dependency on Customers or Suppliers

Excessive reliance on only one customer, or alternatively only one supplier, poses very high risks to a business.

In the event of the only customer's insolvency or withdrawal of orders, the gross margin will drop significantly owing to the sudden reduction in sales. The whole future of the business is put at risk, as there may be no market for its products or services.

Case Study

Reliance on One Sole Customer

NMT Ltd (Spain) is a Small milk farm. For the last 15 years, 40% of the farm's turnover comes from sales to PARMALAT, its main customer – a fact of which the small milk farm is very proud.

Suddenly, PARMALAT came into difficulties, leading to the big multinational becoming insolvent and going through the Italian insolvency procedure. At that time PARMALAT's payables to NMT amounted approximated to 500,000 Euros.

When this happened, NMT had an outstanding debt with its creditors totalling 575,000 Euros. It was no more able to pay it back owing to lack of liquidity caused by the sudden stop in the collection of receivables from PARMALAT. In fact, NMT's banks, suppliers and other creditors lacked confidence in NMT's ability to repay its debts.

The farm was forced to ask for a Suspension of Payments Proceeding in order to restructure its financial situation and protect its assets from any assault by its creditors.

The main <u>causes</u> of NMT business failure can be identified in the following factors:

- Problems in large multinational
- Stigma of failure in the milk sector (everyone gets to know it promptly)
- Reliance on one main customer (40%)
- Sudden lack of credit from financial institutions & suppliers
- Sudden drop in sales in the Italian market

The main <u>effects</u> of the failure are as follows:

- Insolvency (repayment of debts non longer possible)
- Loss of profits as a consequence of loss sales
- Labour market problems
- Stigma of failure for the entrepreneur
- No credit available, especially locally

The same applies in case of reliance on only one supplier, as in the event of a sudden supply failure or break of the commercial relationship, the business will be in danger: because of its entire dependency on the supplier, it will have no alternative sources of supply.

Case Study

Reliance on One Sole Supplier

Dark Steel Ltd (UK) traded profitably for many years starting as a family partnership that developed in to a company with 8 million Euros turnover and sixty employees.

The company purchased steel wire from the large rolling mill steel supplier and less regularly second grade products made up into substantial coils. This wire was then processed into thinning wire with various uses, including wire used for baling and manufacture of goods such as shopping trolleys or filing baskets.

The industry became very competitive and the company sustained losses that eventually affected cash flow.

The Directors found and committed themselves to a supplier who was prepared to supply the steel coils at much reduced prices and allow a level of credit far in excess of other suppliers.

Initially, the company benefited because it could itself become more competitive in the market place and the cash flow position improved.

However, the management of the supplier company had made a fundamental error of judgment because the price it was selling to Dark Steel Limited was not sustainable and it very soon incurred losses and got in to cash flow difficulties itself, with the result that its bankers undertook insolvency procedures against it culminating in cessation of trading.

Overnight Dark Steel Limited lost its source of supply and could not then find an alternative supplier who was prepared to supply at anything like a comparable price, or who would be prepared to provide extended credit.

The Insolvency Practitioners, who were acting for the bank, called in the outstanding debt in full and, as a result, Dark Steel Ltd did not have funds to pay off the debt and pay new suppliers on their terms.

Consequently Dark Steel Ltd itself had to close down and a good well established family business was lost.

It must also be remembered that in case of excessive reliance on only one customer, or alternatively only one supplier, any audit report may include an ‘emphasis of matter’, i.e. an explanatory paragraph highlighting an area of risk, something which is not of course appreciated by stakeholders, such as banks, and would prevent the company from obtaining loans.

1.1.6 Impending Bad Debt

Impeding bad debt is one of the possible causes of business failure that is capable of being predicted in advance. Bad debts may increase significantly, due to the insolvency or disappearance of a customer. This often leads in the long run to insolvency. The main problem for SMEs, though, may be in actually identifying potential bad debts and being able to reduce them. In many SMEs, there will not be an in-house credit collection department which is able to undertake regular credit control activity and follow up matters of going-concern. For this reason, bad debts may have a more dramatic impact on SMEs than on larger businesses.

1.1.7 Overtrading

When the company expands excessively and grows rapidly by taking on more commitments than it is able to cope with, the survival of the business is put at risk.

Hereunder follows a case study on overtrading, which provides a detailed example of such frequent cause of business failure.

Case Study

Overtrading

Mr. A. started a business fitting electronic equipment and systems in business customers’ premises. He would fit and service equipment and provide training for their use to the customer’s staff.

At the outset, Mr. A. had only one client. He would work from home, without separate business premises, and travel to the customer to carry out his work. By keeping overheads low, he soon started to make profits of about 100.000 Euros per year. He wished, however, to expand, acquire premises of his own, employ staff, diversify from his original base and cut down on the time he spent personally at clients.

He asked advice from his accountant. He was told to seek the staged growth of his company and not try to do too much too soon. For as long as he had just the one client, there was no need to acquire business premises of his own. However, his reliance on the one client was a risk to the survival of his business. While he should not lose focus on the relationship with his current client, he should consider putting together an exit strategy to cope with the eventuality that the contract with the single client might be terminated.

Mr. A decided not to take the advice of his accountant as regards overheads and signed a 15-year lease on new premises. He took on five people and acquired company cars for them all. Mr. A also began to allow his new staff to take over fitting duties and to spend more and more of his time trying to computerise all aspects of the business.

Unfortunately, his business soon went from running a small overdraft to an overdraft of over 250.000 Euros, after withdrawing a combined 130.000 Euros for himself and his wife, who was also on the company payroll. His profits dropped to about 8.000 Euros.

Despite these unpromising signs, he pursued his aim of diversifying the business. He became an agent for accounting software packages and leased a further two cars for use by the new staff engaged to train customers. He also built an expensive in-house training facility for clients.

Problems mounted when the time came for the business to re-negotiate its contract with its original sole client. The business was forced to accept a lower price, which meant that its profits would fall further. This put further pressure on its bank overdraft and its cheques started to ‘bounce’.

In the end, the business was unable to survive and the entrepreneur was bankrupt. He did not take his accountant’s advice to put together a realistic exit strategy, he became excessively concerned with the image of his business and lost his focus on the core business of his company, instead of spending time on less important or less profitable matters. Above all, he failed to pursue a policy of sustainable growth and ended up overstretching both his business and himself.

1.1.8 Poor Marketing and Research

Amongst start-up businesses a frequent cause of businesses failure is a lack of adequate and appropriate market research. Market research is required to help businesses to identify their customers and inform them of the size of the potential customer base, to determine what price customers might be prepared to pay and to suggest how demand for the product or service will change according to the price charged. Research will also inform them about their competitors and their likely reaction to a new entrant to the marketplace.

In a new business this information is vital to enable the company to calculate whether it will make sufficient gross margins to cover its overheads and financing costs and make an adequate profit.

More established businesses will have addressed some of these issues. However they need to be constantly aware of how their marketplace is changing, what their competitors are doing and planning, who can be the potential new entrants to the marketplace and how they will affect their trade.

1.1.9 Fraud/Collusion

Finally, fraud and collusion, where not detected in good time, can also cause significant financial loss and reduction of business performance.

The most typical case of fraud is the one committed by employees, namely by falsifying expense reports or by stealing small unit-value items, such as stationery or cleaning products. When such thefts happen regularly, and are left uncontrolled, they can lead to significant losses.

Collusion with the stakeholders of the business can also have serious consequences. The employee may make a secret agreement with a supplier whereby the delivery is lower than that indicated by the invoice, and the employee is paid remuneration for the so-called 'favour'. Similar secret agreements can be made by an employee and a customer, arranging that the latter receive more goods or services than that indicated by the invoice, in return for compensation to the fraudulent employee. Other secret deals can be made by the employee responsible for treasury with the banks operating with the business.

Additionally fraud can be also perpetrated by the entrepreneur or their spouse, or by a trusted advisor.

1.2 External Causes of Business Failure

External factors which in the long run may cause SMEs to fail cannot always easily be predicted, since they may involve extraordinary or unusual events happening in the region or country where the company operates, events over which the business has no influence.

The most frequent unpredictable external causes are listed below:

1.2.1 Economy

A recession in the economy, either at EU level or at national level, represents one unpredictable event, as well as a sudden decline in the specific field of activity of the business may also cause insolvency of the business.

Other possible issues generally related to market economy, which might threaten business failure, are indicated as follows:

- Change of buying patterns: likely to be influenced by socio-political developments (i.e. increasing importance of environmental compatibility of industrial products);
- Decreasing purchasing power of consumers or groups of consumers: could produce as a consequence decreasing wages or unemployment;
- Shortage of raw materials: often linked to a significant increase of costs, it may cause deadlines related to production and supply not to be met;
- Customers' strikes: they may provoke significant damages at the level of the supplying enterprises;
- Low price competitors: they usually try to convert market segments by using dumping prices, they produce cheaper than other competitors or are subsidised;
- Substitution products: they often lead to changes in the market and in the preferences of consumers.

1.2.2 Catastrophic Unpredictable Events

Natural disasters such as fire, floods, earthquakes and terrorism cannot normally be foreseen in advance.

The only possible way to cover such risks is to prudently insure against them, especially if the region in which the business operates is frequently subject to environmental disasters. Even in this case, a delay in obtaining the indemnity from the insurance company may damage the business's cash flow.

1.2.3 Governmental Measures and International Developments

Strict governmental measures may affect specific sectors of business activity and impose stringent burden on SMEs. International developments, like war treaties or trade agreements, may have similar effects.

Such developments cannot always be predicted, although the entrepreneur can keep himself always up to date following the financial press.

1.2.4 Environmental Protection and Other Regulatory Requirements

Measures to protect the environment and other similar social protection measures can have financial implications for businesses, both in terms of cost of compliance and of financial penalties which may be imposed by the authorities in case of non-compliance.

1.2.5 Bankruptcy of Main Customer or Supplier

It has already been mentioned (paragraph 1.1.5) that a business which is overly dependent on one sole customer or supplier is likely to be at higher risk than a business that has a variety of customers and suppliers to trade with.

Whenever the customers or suppliers concerned are experiencing financial problems, they will pass on their problems to the business. For instance, if the sole customer is no longer able to pay its bills on time, the seller will be short of cash, and will start having problems in paying back its own suppliers.

Similarly, in the case of manufacturing companies, where the sole supplier goes bankrupt, no more goods will be received, causing a stop in the production process; the same will apply in the case of services or retail companies, which will no longer be able to meet their sales and delivery commitments whenever the sole supplier experiences failure. The bankruptcy of a sole supplier will obviously threaten the on-going relationships of the business with its customers.

2 EFFECTS OF BUSINESS FAILURE

Business failure can produce effects not only for the company itself, but also for its stakeholders; the result can be serious damage to businesses in the short term and the mid-long term as well. This chapter will present a brief overview of the main effects of business failure; it does not intend to provide a comparison among the legal aspects of business failure in Europe.

2.1 Effects for the Company

Where an SME becomes insolvent and cannot be rescued, the most common effect for the company itself is *bankruptcy*, with legal consequences which vary from country to country.

An outcome of failure which is common to all countries is the *stigma of failure* for the entrepreneur, who will encounter serious difficulties in starting up again with a new business. However, as recommended by the European Commission[8], which is leading attempts to develop a more entrepreneurial culture in Europe, failure is considered a valuable learning experience and entrepreneurs are encouraged to make a fresh start.

Whenever possible, the entrepreneur might try to rescue the business by form of agreements between entrepreneurs, creditors, employees, and other parties with a commercial interest. A 'rescue culture' in all Member States is actively being promoted by the European Commission[9].

If restructuring was not possible, the usual result of failure would be the sale of the business as a going concern which would achieve the best result for creditors. Whenever the business is insolvent and cannot be restructured, it has no future. Assets should be liquidated by means of collective insolvency proceedings (i.e.: liquidation, etc), for which the legal framework for mutual recognition varies from country to country.

The ultimate consequence of business failure is usually the *closure of the business*.

2.2 Effects for Stakeholders

The failure of an SME also affects its stakeholders, i.e. all the people who have any kind of commercial relationship or commercial interest with the company, namely employees, customers, suppliers, banks, entrepreneur's family, directors, etc.

Once a business has failed, the *employees* are made redundant. This might cause serious economic problems especially for the employees based in poor regions where unemployment rates are rather high and finding a new job is relatively difficult.

Suppliers who cannot be fully repaid would of course suffer economically, especially those who were dependent on the SME which failed as their main or only customer. The same would apply for customers who rely mainly on the failed SME: they would lose their market. Frequently the severest effects on the local economy are felt by local trade people (i.e. bakers, butchers, etc).

[8] 'Helping businesses overcome financial difficulties – A guide on good practices and principles on restructuring, bankruptcy and a fresh start'. Office for Official Publications of the EC, 2002.
[9] ibidem

Small *local banks* having provided significant loans to failed SMEs would find themselves into financial difficulties as the result of having to write off the debts owed to the bank.

Where there is unlimited responsibility for the entrepreneur, failure would also cause a financial loss for the *entrepreneur and his family*.

In the case of SMEs having the limited responsibility legal form, *directors* will not be held financially responsible for the company's debts because of the legal principle that the company structure is a legal entity separate from the individuals who own and control it.

However, the directors should not assume that if their company fails and has to be wound up, they would automatically be immune from legal action against them even if they have acted responsibly. In its May 2003 Communication on Company Law[10], the European Commission indicated its plans to develop common EU-wide legal rules on the following two issues:

- Wrongful trading: the directors would be personally accountable for the consequences of the company's failure, if it was foreseeable that the company cannot continue to pay its debts and the directors did not decide either to rescue the company and ensure payment or to put it into liquidation;
- Directors' disqualification: directors would be disqualified in case of misleading financial statements and non-financial information and for other forms of misconduct.

In some countries, the law already makes provision for the conduct of directors of insolvent companies to be reviewed. Specific transactions, such as where the company has paid dividends to its directors or shareholders when it has not, technically, had sufficient funds to pay them, may be overturned and the director or shareholders concerned will be required to repay the money they paid to themselves. The law may also provide for the directors to assume personal liability for some of the insolvent company's debts if the directors are considered to have failed in their duties to shareholders and creditors.

[10] Communication from the European Commission to the European parliament 'Modernising Company Law and Enhancing Corporate Governance in the European Union – A Plan to Move Forward. 21 May 2004.

3 AVOIDING BUSINESS FAILURE

3.1 Pre-Emptive Actions

Entrepreneurs of SMEs should be ready to take up all the necessary actions in order to prevent a business failure. Businesses rarely fail suddenly: Failure is a gradual process which usually involves a downward spiral. However, sometimes failure results from ambitious expansion plans not accompanied by the appropriate level of finance. It should be stressed that entrepreneurs should have a *proactive approach*, taking the necessary actions as soon as financial problems become apparent.

As mentioned in the last chapter, external causes of business failure cannot always be predicted with accuracy in advance, while the overwhelming majority of factors leading to failure are preceded by premonitory signs of insolvency. Therefore, entrepreneurs should be trained in order to be able to detect and identify warning signs in good time.

3.1.1 External Advice

Advice from professionally qualified financial accountants should be sought regularly, beginning at the start up phase, and continuing through all the stages of business life. Entrepreneurs need to be aware of the benefits of acquiring basic financial management skills to take advantage of any opportunities of growth and to anticipate any threats to the survival of the business, reacting to them promptly. Management education should be provided even before starting out in business.

There is a key role of professionally qualified accountants in areas such accounting, financial planning and credit management. Bookkeeping and Financial Reporting practices should be according to recognised accounting principles and sound business practice, in order to produce high quality financial information, which sets the ground for the efficient and effective growth and the survival of the business.

3.1.2 Planning, Budgeting and Forecasting

A well-run business will have controls in place to monitor the business plans and an information system which regularly updates the management on progress towards its objectives. Controls should also give an early warning that the trading performance is deteriorating and provide pointers to steps which should be taken to correct the situation.

Many large companies undertake some very advanced financial modelling based on a number of possible future possibilities. However, planning, budgeting and forecasting are vital tools for SMEs as well, although they will not usually need to be as sophisticated as the corresponding procedures in larger companies.

The following paragraphs describe the systems which offer management the opportunity to control and manage the business. If an SME does not have the resources in-house to prepare the information, external accountants can help to devise a simplified system of planning, budgeting and forecasting which summarises key performance indicators and provides a feedback mechanism.

Strategic Plans

Preparing a strategic business plan is an important step in developing a long-term view of where the business is going and how it plans to get there. It is particularly relevant at critical times during an SME's development phase.

The key issues to be addressed in a strategic business plan include marketing and financial issues.

Key marketing issues:

- The products or services currently offered and the potential developments to the range of products;
- The customer base and how it might be expanded;
- The distribution channels currently employed and alternative strategies for the future.

Key financial issues:

- The current level of funding and the requirements for future developments,
- The anticipated profitability and cash flow of the business,
- The current and future return to investors.

Business plans must be a constant reference point for the management and updated periodically as the business progresses towards its goals.

Business Plans for Finance Providers

When a business is considering raising finance, the benefits of having a strategic plan become apparent as the key marketing aspects of the business will be well established. However, the plan for finance providers needs to cover a wider range of issues to provide parties new to the business with a brief picture of its history, product range, management and business prospects. Potential finance providers will expect to see the following issues covered in addition to the marketing information extracted from the strategic plan:

- How the business plans to deliver the anticipated sales projections;
- The current facilities and plans for expansion or upgrading;
- The management and staff of the business (including positions, experience, qualifications, etc.);
- The current ownership;
- Key financial information for the last 3/5 years with forward projections for the next 3/5 years.

The plan will enable the business to sell itself to potential investors and finance providers.

Budgeting

It is vital to prepare annual budgets to decide a plan for the business in the following years and to provide a yardstick by which progress can be measured. The management should be able to know whether the business is achieving its targets and if not, to see the variances from the annual target. Budgets are best prepared with a 'bottom up' approach, so that all the people involved are committed to the eventual targets even if the directors have to amend the resulting consolidated budget to achieve the business' goals.

Budgets should be based upon anticipated sales targets (broken down into product lines and number of units/quantities) and anticipated selling prices. The availability of software packages enables budgets to be ‘flexed’ and to include ‘what if’ questions (i.e.: ‘What happens if selling prices are reduced by 5%?’). Phasing the sales into months will help other departments within the business (i.e.: the production department of a manufacturing business) plan the resources required throughout the year to meet the sales budgets.

Once the sales levels are planned, the budgets related to the accompanying direct costs, staffing and overhead can be prepared. The capital expenditure budget is frequently the most contentious of the budgets as it is often the key to deciding how a business intends to develop.

The further step is to plan the working capital requirements: levels of stock and work in progress, debtors and creditors. A Balance Sheet and Cash Flow Budget can be prepared. The phasing of sales and costs allows identifying when during the year the requirements for finance are greatest and if the financing facilities will be sufficient for the business’ needs.

A simple budget prepared as described above will allow the management to take a first high-level view of the resulting performance and assess whether the overall performance is satisfactory and whether the results are in line with the business plan. It will be also possible to foresee whether the shareholders and finance providers will be satisfied with the results and whether further finance will be required and, if so, what types of finance will be appropriate (i.e. debt, equity, asset based finance, guarantees, etc.).

If the management are not satisfied with the answers to these questions, they need to consider what changes can be made to achieve the desired outcomes, i.e. setting a less ambitious sales budget to keep the financing requirements within known facilities.

Once the budget has been settled, it becomes the yardstick for measuring performance over the next year.

Management Accounts

Having set the targets, it is important to monitor progress through the preparation of monthly (or quarterly) management accounts. Unlike statutory accounts, management accounts can be in any format the management chooses; usually they would include information on:

- Sales by quantity and value,
- Direct Costs,
- Gross Profit by product or service,
- Overheads,
- Operating profit,
- Interest,
- Net Profit.

The management accounts might also include non-financial information such as sales or marketing statistics, labour costs, etc. and are usually accompanied by a narrative. Significant variances from budget would be explained as well as agreed actions to get the business back on budget.

Forecasting

If cash flow becomes critical, or there is a danger the business might exceed its financing facilities, a short term cash flow forecast can help plan a way forward, either until position stabilises or until it is appropriate to discuss the situation with stakeholders or finance providers.

It is advisable for businesses with cash flow problems to prepare a daily forecast of receipts and payments to calculate how much can be paid to the most pressing creditors as well as highlighting the actions required to generate additional cash flow. The availability of forecasting spreadsheets makes preparation of ad-hoc forecasts easier and often more meaningful. In case the management decides that the annual budget is no longer relevant to the business, then ad-hoc forecasts can be substituted.

With the assistance of this short term forecasting the management can often manage the business through a cash crisis until the situation has stabilized or until it can devise appropriate longer term solutions.

3.1.3 Audit

Where the financial statements of the company are audited, the entrepreneur will have a higher level of assurance that the company’s financial information provides a sound basis for economic decisions. Independent audit is also a deterrent against fraud and increases the likelihood that any frauds committed will be detected.

For this reason, it is advisable also for those companies for which audit is not compulsory by national law to commission a voluntary audit of their financial statements. This will enhance the credibility of the company’s financial reporting and results, especially from the perspective of banks.

If the audit report includes a qualified, disclaimer of or adverse opinion, or an ‘emphasis of matter’ paragraph in which the auditors stress a going concern problem or a significant uncertainty of which the resolution is dependent upon future events and which may affect the financial statements (tax or other litigations etc.), it is important for entrepreneurs to solve the identified problems as they represent causes of potential insolvency of the business. To this extent, the audit process can offer helpful early warnings of possible problems the business is facing.

Auditors’ involvement may also provide value added in that a discussion can take place on the risks facing the company. The auditors will be able to provide advice in identifying the more risky areas and the appropriate control measures to implement in order to tackle risks.

3.1.4 Cash Flow Statements

A cash flow statement is one of the most useful financial management tools to assess the timing, amount and predictability of future cash flows and can be the basis for budgeting. In Europe from January 2005 cash flow statements will be compulsory for listed companies, as they have to prepare their consolidated financial statements according to IFRS[11]; However, regardless of any law obligation, a cash flow statement can be very useful for SMEs as well.

Information about the cash flows of an enterprise is useful in providing users of financial statements with a basis to assess the 'ability of the enterprise to generate cash and cash equivalents and the needs of the enterprise to utilise those cash flows'[12]. The economic decisions that are taken by users require an evaluation of the ability of an enterprise to generate cash and the timing and certainty of their generation.

When used in conjunction with the rest of the financial statements, a cash flow statement provides information that enables users to evaluate the changes in net assets of an enterprise, its financial structure (including its liquidity and solvency) and its liability to affect the amounts and timing of cash flows in order to adapt to changing circumstances and opportunities. A cash flow statement is a key to understanding the investment and financing philosophy of a borrower; it will be used by banks to assess whether the business has enough cash to generate cash to repay a loan.

Cash flow information also enables users to develop models to compare the present value of the future cash flows of different enterprises; It enhances the comparability of the reporting of operating performance by different enterprises because it eliminates the effects of using different accounting treatments for the same transactions and events.

The cash flow statement should report cash flows during the period classified by operations, investing and financing activities.

Operating Activities

The amount of cash flows arising from operating activities is a key indicator of the extent to which the operations of the enterprise have generated sufficient cash flows to repay loans, maintain the operating capability of the enterprise, pay dividends and make new investments without recourse to external sources of financing. Information about the specific components of historical operating cash flows is useful, in conjunction with other information, in forecasting future operating cash flows.

Cash flows from operating activities are primarily derived from the principal revenue-producing activities of the enterprise. Therefore, they generally result from the transactions and other events that enter into the determination of net profit or loss.

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[11] According to regulation nr. 1606/2002 (IAS Regulation), for financial years starting on or after 1 January 2005, listed companies will have to prepare their consolidated accounts in conformity to IFRS.
Member States may <u>permit</u> or <u>require</u> the use of IFRS also for:

- The annual accounts of listed companies,
- The annual or consolidated accounts of other than listed companies.

[12] Source: IAS 7

Investing Activities

The separate disclosure of cash flows arising from investing activities is important because the cash flows represent the extent to which expenditures have been made for resources intended to generate future income and cash flows.

Financing Activities

An enterprise should report cash flows from operating activities using either:

a) The direct method, whereby major classes of gross cash receipts and gross cash payments are disclosed; or
b) The indirect method, whereby net profit or loss is adjusted for the effects of transactions of a non-cash nature, any deferrals or accruals of past or future operating cash receipts or payments, and items of income or expense associated with investing or financing cash flows.

The separate disclosure of cash flows arising from financing activities is important because it is useful in predicting claims on future cash flows by providers of capital to the enterprise.

Further details on cash flow calculation can be found in Appendix 5.2.

3.1.5 Ratios

An effective business strategy can be developed only after an accurate analysis. Entrepreneurs should consider monitoring of business performance and planning, together with a subsequent gap analysis between actual and budget, as regular activities.

Benefit can be drawn from the financial statements when they are compared to other statistics: such comparisons are the essence of why business and financial ratios are developed. The monitoring of such indicators can help in taking appropriate and prudent decisions related to investment and loan finance.

In order to assess how the business is doing, various ratios can be established from key figures on the financial statements. These ratios are very simple to calculate - sometimes they are simply expressed in the format 'x/y'. They can be a powerful tool because they provide an easily understandable summary of the relationship between the figures involved.

When ratios are routinely calculated and recorded at the end of every accounting period, this allows assessing the business performance over time, and comparing the business to others in the same industry or to others of a similar size. Besides, banks routinely use business ratios to evaluate a business that's applying for a loan, and some creditors use them to determine whether to extend credit.

When comparing changes in the business's ratios from period to period, one can pinpoint improvements in performance or detecting problem areas. By comparing the ratios to those in other businesses, possibilities for improvement in key areas can be identified. A number of sources, including many trade or business associations and organisations, provide data for comparison purposes; they are also available from commercial services. Professional Accountants may be a good source of information on how the business compares to similar ones in the particular locale.

The appendix 5.3 explains some of the different kinds of ratios which can be used by SMEs.

3.1.6 Procedures and Management of Risk

Finally, other efficient tools to avoid business failure in an SME can be borrowed from the organisational structure of larger companies, adapting them to the specific needs of SMEs.

Basically, both internal control and risk management systems allow the business to have a proactive approach, identifying in due time any threats to the survival of the business itself. SMEs cannot easily develop complex internal control and risk management systems, like larger companies, mainly owing to the fact that costs would be excessive and the structure of the organisation not sufficiently large. Therefore, SMEs should try to set up equally effective but less sophisticated and cheaper systems.

Even if it is performed informally, it is important that SMEs follow the basic approach of *risks identification* outlined below:

- Identify responsibility and reporting lines for risk;
- Determine the company's risk exposure;
- List risks;
- Define appropriate action for risks – accept/transfer (usually via insurance)/reduce/manage/ eliminate;
- Monitor regularly through better risk reporting;
- Learn the lessons and feedback into the process.

In addition, rather than implementing a complex internal control system, SMEs could write down *simple policies and basic procedures*, which should be clearly stated and communicated.

The procedures should foresee a clear description of the business process, including inventory, production cycle, purchase/sale cycle and banks. Each phase of the cycles should be briefly described. Paragraphs related to division of responsibilities and authorisation requirements should also be added. Checkpoints should be foreseen to reduce risk. A person should be delegated to check that all the procedures are respected; that person should be required to affix a visible mark (a stamp or signature) to show that a control has taken place. It could be either the entrepreneur, somebody he trusts, or an external financial accountant or other expert.

4 RESCUE PROCEDURES

It has been generally agreed by the EU Member States that there is a need to avoid the 'stigma of failure', so as to allow entrepreneurs to start up in business again without unreasonable restrictions. During the Noordwijk EC Conference of May 2001 'Company Failure in the EU' it was proposed that more should be done to encourage businesses to restart following bankruptcy. The conference also made suggestions for how business failure could be avoided. Transparency of financial information, proper annual audits and enhancing the responsibilities of directors were amongst the main proposed solutions[13].

SMEs can be rescued from failure either by taking appropriate measures for the recovery of the business or by the transfer of the business to another entrepreneur. Where restructuring is not possible, the best result for creditors can be achieved by selling the business. Finally, the business should be liquidated where there is no future for it.

As mentioned before, this guide is primarily addressed to entrepreneurs of SMEs. Therefore it intends to analyse the necessary actions in order to rescue SMEs *without* any change in the ownership. This can be done essentially in two ways:

- By means of legal insolvency procedures,
- By agreements outside the judicial system.

The most effective way of rescuing a business is reaching possible agreements with creditors outside the judicial system. Informal arrangements with creditors, such as a debt for equity swap, should be preferred, as they save costs time and bad publicity.

Wherever agreements cannot be reached outside the judicial system, then collective insolvency procedures will apply. The law applicable to insolvency proceedings and their effects is usually that of the Member State within the territory of which such proceedings are opened.

However, where the failure of the business involves stakeholders (customers, banks, etc.) of different Member States, then it is the European Union Regulation on insolvency proceedings[14] which will apply with supra-national force. The Regulation entails the divestment of the debtor and the appointment of a liquidator. Its aim is to save companies in crisis whenever possible, and in every case when the social cost of doing so is less than the benefits that would be obtained from it (see the Appendix for further details).

[13] 'Helping businesses overcome financial difficulties - A guide on good practices and principles on restructuring, bankruptcy and a fresh start', published by DG Enterprise of the EC, 2002
[14] Council Regulation (EC) No 1346or2000 of 29 May 2000 on insolvency proceedings

5 APPENDIX

5.1 Insolvency Legal Framework for Mutual Recognition at the European Union Level

The legal framework for mutual recognition in the insolvency field is defined by the European Regulation on Insolvency Proceedings[15], which came into force in May 2002. The Regulation covers collective insolvency proceedings which entail the divestment of the debtor and the appointment of a liquidator. It does not apply to insurance and credit institutions.

The Regulation is structured into five chapters: General provisions, Recognition of insolvency proceedings, Secondary insolvency proceedings, Provision of information for creditors and lodgement of their claims, and Transitional and Final Provisions. Considerations of the EU Council precede the chapters and describe the spirit and finality of the law. The aim is to save companies in crisis whenever possible, and in every case when the social cost of doing so is less than the benefits that would be obtained from it.

The opening of an insolvency procedure in a Member State will be recognised by the other Member States of the EU, without impeding the opening of other secondary proceedings in other Member States. The principal procedure will be in the State in which the debtor has his or her centre of principle interests (his or her establishment).

The liquidator will be able to exercise all his powers in another Member State, including the transfer of assets from the debtor outside of the Member State where the assets lie. Furthermore, he will be able to carry out whatever repealed action that the proceedings agree. Where there are various proceedings and liquidators, the latter should cooperate and exchange information.

It falls to the Court or to the liquidator to inform all the creditors of the opening of the insolvency proceedings, explaining the procedures and timing to follow. The insinuation of credit can be conducted as much in the principal procedure as in the secondary. The effects of the secondary proceedings of insolvency will be limited to the assets of the debtor located in the territory of the said Member State.

Two annexes are included in the Regulation, the first relating to the name of the different bankruptcy procedures in the Member States, and the second as regards the names of the people that carry out functions equivalent to those assigned to the liquidator.

[15] Council Regulation "(EC) No 1346 of 29 May 2000 on Insolvency Proceedings"

5.2 Preparing Cash Flow Statements

There are two possible approaches to reporting cash flow from operating activities: the direct and the indirect method. The choice of method does not change the amount of cash flow reported from operating activities: The direct method and indirect method are just two routes to the same destination. It may be considered that the direct method is not the most widely used method to calculate the cash flow from operating activities: many companies use rather the indirect method.

Direct Method

Enterprises are encouraged to report cash flows from operating activities using the direct method. The direct method provides information which may be useful in estimating future cash flows and which is not available under the indirect method. Under the direct method, information about major classes of gross cash receipts and gross cash payments may be obtained either:

a) From the accounting records of the enterprise; or
b) By adjusting sales, cost of sales (interest and similar income and interest expense and similar charges for a financial institution) and other items in the income statement for:

    (i) Changes during the period in inventories and operating receivables and payables;
    (ii) Other non-cash items; and
    (iii) Other items for which the cash effects are investing of financing cash flows.

Here follow examples of direct method cash flows for operating, investing and financing activities according to IAS 7:

Cash Flow from Operating Activities:

+ Cash received from customers
- Cash paid to suppliers and employees
- Cash generated from operations
- Interest paid
- Income taxes paid
- Extraordinary items, if any (natural disasters, etc)
= Net Cash from Operating Activities (A)

Cash flows from investing activities

- Acquisition of subsidiary X, net of cash acquired
- Purchase of property, plant and equipment
+ Proceeds from sale of equipment
+ Interest received
<u>+ Dividends received</u>
= Net cash used in investing activities (B)

Cash flows from financing activities

+ Proceeds from issuance of share capital
+ Proceeds from long term borrowings
- Payment of finance lease liabilities
- Dividends paid
= Net cash used in financing activities (C)

Net increase in cash and cash equivalents (A+ B+C)
+Cash and cash equivalents at beginning of period
= Cash and cash equivalent at end of period

Any use of cash (such as payments to suppliers or employees) is subtracted and any source of cash (such as cash sales) is added to compute total net cash from operating activities.

While it seems simple enough, there are various reasons that many companies do not opt for this format. One reason may be the number of calculations necessary to compute some of the categories, such as cash received from customers. While computerised accounting systems could make this relatively easy, a SME with many small cash sales and a manual accounting system might find it harder to determine total cash received.

Indirect Method

Under the indirect method, the net cash flow from operating activities is determined by adjusting net profit of loss for the effects of:

a) Changes during the period in inventories and operating receivables and payables;
b) Non-cash items such as depreciation, provisions, deferred taxes, unrealised foreign currency gains and losses, undistributed profits of associates, and minority interests; and
c) All other items for which the cash effects are investing of financing cash flows.

Alternatively, the net cash flow from operating activities may be presented under the indirect method by showing the revenues and expenses disclosed in the income statement and the changes during the period in inventories and operating receivables and payables.

Here follow examples of indirect method cash flows for operating, investing and financing activities according to IAS 7:

Cash Flow from Operating Activities:

Net profit before tax and extraordinary items

Adjustments for:
+ Depreciation
+ Foreign exchange loss
+ Investment income
+ Interest expense

- Increase in trade and other receivables
+ Decrease in inventories
- Decrease in trade payables
Cash generated from operations
- Interest paid
- Income tax paid
Cash flow before extraordinary items
+ Extraordinary items, if any

=Net cash from operating activities (A)

Cash flows from investing activities

- Acquisition of subsidiary X, net of cash acquired
- Purchase of property, plant and equipment
+ Proceeds from sale of equipment
+ Interest received
+ Dividends received
= Net cash used in investing activities (B)

Cash flows from financing activities

+ Proceeds from issuance of share capital
+ Proceeds from long term borrowings
- Payment of finance lease liabilities
- Dividends paid
= Net cash used in financing activities (C)

Net increase in cash and cash equivalents (A+ B+C)
+Cash and cash equivalents at beginning of period
= Cash and cash equivalent at end of period

Sources and Uses of Funds

In order to identify what adjustments are necessary, it might be useful to construct a Sources and Uses of Funds statement based on the company's ledger accounts. Changes in the accounts (i.e. increases or decreases) are organised as to whether cash came into the company (a source of cash) or cash left the company (a use of cash). Activities are classified as operating, investing, or financing activities. Each ledger account is analysed to see if a change affecting cash occurred. If it did, then the amount of the change is noted.

Once a Sources and Uses of Funds table is completed, each Balance Sheet change should be classified as to whether it is an operating, financing, or investing activity (as shown in the column on the far right). Then the information can be recorded to the cash flow statement.

How to Analyse a Cash Flow Statement

The Sources and Uses of Funds Worksheet can be used to complete the indirect method cash flow worksheet. Transactions should be grouped according to operating, investing, and financing activities. (Changes to cash, accounts receivable, inventory, depreciation and amortization, and accounts payable will most likely be operating activities. Cash changes due to equipment or asset purchases will be investing activities. And changes due to paying down debt or loan payments and payments of dividends will be financing activities).

Once the cash flow statement is constructed, the financial position of the company will be understood more closely.

Operating Activities

The cash flow statement provides information on where money came from and how it was used. When analysing cash flows, the first place to look is the cash flow from operating activities. It says you whether the company generated cash or whether it needs a cash infusion.

A few periods of negative cash from operating activities is not by itself a reason for alarm if it is based on plans for company growth or due to a planned increase in receivables or inventories. However, if a negative cash flow from operating activities is a surprise to managers and entrepreneurs, it may be undesirable. Over time, if uncorrected, it can foretell business failure. Managers and entrepreneurs should pay particular attention to increases in accounts receivable. The cash flow statement gives the true picture of the account. A large increase in accounts receivables may warrant new billing or collection procedures.

Investing Activities

The cash flow statement puts investing activities into perspective, showing at one glance, whether or not a surplus in operations is being used to 'grow' the company. A lack of investing activities, i.e. is few purchases of new equipment or other assets, may indicate stagnant growth or a diversion of funds away from the company.

Financing Activities

The financing activities section of the cash flow statement will show repayments of debt, borrowing of funds, as well as injections of capital and the payment of dividends. As a company expands, this area of the cash flow statement will become increasingly important. It will tell outsiders how the company has grown as well as the financial strategies of management.

Together, the three sections of the cash flow statement show the net change in cash during the period being examined. A comparison between past periods will give entrepreneurs and managers a good idea of the trend of their business. Positive trends in cash flow may encourage entrepreneurs to consider long-term financing as an aid to growth and increase their comfort level concerning the company's ability to generate cash for repayment. Strong cash flow will also make it easier to acquire financing and to negotiate with lenders from a position of strength. Preparation of a cash flow statement is the first step toward financial management for long-term success. Prepared on a regular basis, it is a powerful tool for growth and long-term success.

5.3 Ratios

There are different kinds of ratios: this guide will provide an overview on those on liquidity, solvency and profitability only. It must however be highlighted that SMEs can also develop their own private ratios, appropriate to their business sector or niche market.

Liquidity Ratios

Liquidity ratios are probably the most commonly used of all the business ratios. Creditors may often be particularly interested in these because they show the ability of the business to quickly generate the cash needed to pay the bills. This information should also be of high interest to SMEs themselves, since the inability to meet short-term debts would be a problem that deserves immediate attention.

The most common liquidity ratios are Current Ratio and Quick Ratio.

Current Ratio = current assets/current liabilities

The *Current Ratio* is a way of looking at the working capital (difference between current assets and current liabilities) and measuring short-term solvency. The ratio is in the format x/y, where *x* is the amount of all current assets [16]and *y* is the amount of all current liabilities.
Generally, the Current Ratio shows the ability of the business to generate cash to meet its short-term obligations. A decline in this ratio can be attributable to an increase in short-term debt, a decrease in current assets, or a combination of both. Regardless of the reasons, a decline in this ratio means a reduced ability to generate cash.

Quick Ratio = current assets less inventory/ current liabilities

The *Quick Ratio*, also known as the acid test, serves a function that is quite similar to that of the current ratio. The difference between the two is that the quick ratio subtracts inventory from current assets and compares the resulting figure (also called the quick current assets) to current liabilities.

In fact, as inventory can be turned to cash only through sales, the quick ratio provides a better picture of the ability of the business to meet its short-term obligations, regardless of sales levels. Over time, a stable current ratio with a declining quick ratio may indicate that too much inventory has been built up.

Liquidity ratios are commonly examined by banks when they are evaluating a loan application. Once the loan is obtained, the lender may also be required that to continue to maintain a certain minimum ratio, as part of the loan agreement. For that reason, steps to improve liquidity ratios are sometimes necessary.

[16] Generally, *current assets* are cash or items that will be converted into cash within a year. Some typical current assets are: cash; inventories of raw materials; prepaid expenses such as rent, insurance, and interest; and receivables. The relationship between current assets and current liabilities tends to show the business's ability to pay off its debt during the normal course of operations.

Solvency Ratios

The solvency ratios are designed to help measuring the degree of financial risk faced by the business. ‘Financial risk,’ in this context, means the extent to which debt obligations must be met, regardless of cash flow. By looking at these ratios, the business can assess its level of debt and decide whether it is appropriate or not.

Here are presented some of the most commonly used solvency ratios.

Debt-to-Equity Ratio

The debt-to-equity ratio can be computed with the following formula, using figures from the Balance Sheet:

Debt-to-equity ratio = Total debt/owner’s (Stockholders’) Equity

The ratio of debt-to-owner’s equity or net worth indicates the degree of financial leverage used to enhance return. A rising debt-to-equity ratio may signal that further increases in debt caused by purchases of inventory or fixed assets should be restrained.

Improving this ratio involves either paying off debt or increasing the amount of earnings retained in the business until after the balance sheet date. For instance, expenses can be deferred beyond year end’s date to increase retained earnings and delaying any planned bonus expense serves to increase retained earnings. Another example might be repaying revolving debt (such as a line of credit) before the balance sheet date and borrowing again after the balance sheet date.

Debt to Assets

This ratio can be calculated using the following formula:

Debt to Assets = Total debt / Total Assets

The Debt-to-Assets measures the percentage of assets financed by creditors, compared to the percentage that have been financed by the business owners. Historically, a Debt-to-Asset ratio of no more than 50 percent has been considered prudent. A higher ratio indicates a possible overuse of leverage, and it may indicate potential problems meeting the debt payments.

Improving this ratio means taking steps to either increase the value of assets, or to pay off debt. For example, it can be explored whether inventory or other assets can be given a higher value. If the business starts paying off debt, Current ratio and Debt-to-Equity ratios will be improved.

Coverage of Fixed Charges

Coverage of fixed charges is also sometimes called ‘times fixed charges earned’. It can be computed by taking net income before taxes and fixed charges (debt repayment, long-term leases, preferred stock dividends etc.), and dividing it by the amount of fixed charges. The resulting number shows the business ability to meet its fixed obligations of all types, the higher the number, the better.

Obviously, an inability to meet any fixed obligation of the business threatens the business’s well-being. Many working capital loan agreements will specify that this ratio must be maintained at a specified level, so that the lender has some assurance that the business will continue to be able to make its payments.

Interest Coverage

Interest coverage is also sometimes known as the ‘times interest earned ratio.’ It is very similar to the coverage of fixed charges ratio but focuses more narrowly on the interest portion of debt payments.

The following formula can be used to calculate this ratio:

Interest Coverage = Operating Income / Interest expenses

By comparing the ratio of operating income to interest expense, one can measure how many times interest obligations are covered by earnings from operations. The higher the ratio, the bigger the ‘cushion’ and the more able is the business to meet interest payments. If this ratio is declining over time, it’s a clear indication that financial risk is increasing.

Profitability Ratios

Profitability ratios allow assessing the profitability of the business and changes in its profit performance. These ratios are probably the most important indicators of the business’s financial success. Investors will be interested in these ratios insofar as they demonstrate the performance and growth potential of the business.

ROS (Return on Sales)

The Return on sales can be calculated using the following formula, with figures taken from the Income Statement:

ROS = Operating Income / Sales

This ratio is designed to provide an accurate idea of how much money the business is making on primary business operations. It shows the percentage of sales remaining after all normal costs of operations. By looking at this ratio over time, one can get a fix on whether overall costs are trending up or down.

Gross Profit Margin

The Gross Profit Margin can be calculated with the following formula, using figures taken from the Income Statement:

Gross Profit Margin = Gross Profit / Sales

This ratio is basically the amount of sales remaining after the cost of goods sold has been deducted. If is declining over time, it may mean that inventory management needs to be improved, or that selling prices are not rising as fast as the costs of the goods sold. If the business is a manufacturer, it may mean that production costs are rising faster than prices, and adjustments on either side (or both) are necessary.

ROI (Return on Investment)

Return on Investment is the ratio of earnings before interest and taxes (EBIT) to total assets. It measures what has been earned on the investment in the business during the accounting period.

$$\text{ROI} = \frac{\text{EBIT (Earnings before interest and taxes)}}{\text{Total Assets}}$$

The ROI can be compared to what might be earned investing in other forms (on the stock market, bank deposits, etc) during the same period. Over time, the business should be generating at least the same return that can be earned in more passive investments like stocks, bonds, and bank current deposits. A high ROI may be a result of a high return on assets, extensive use of debt financing, or a combination of the two.

ROE (Return on Equity)

The return on equity ratio can be calculated using the following formula:

ROE = Net income / Equity

The ratio of net income (from the income statement) to net worth or stockholders' equity (from the balance sheet) shows what has been earned on the equity during the accounting period.

In analysing both ROE and ROI, the effects of inflation on the book value of the assets must be considered. While the financial statements show all assets at their book value (i.e. original cost minus depreciation), the replacement value of many older assets may be substantially higher than their book value. A business with older assets, generally, should show higher return percentages than a business using newer assets.

5.4 Statistics at European Union Level

The statistics show that in 1999 there have been approximately 172.000 insolvency procedures in the European Union (which included fifteen Member States at that time). The figures demonstrate that the trend was decreasing of 4% compared to 1998.

France, Germany, Italy, the Netherlands, Sweden and Spain registered a decrease in insolvency procedures, while in countries such as Austria, Ireland and the UK the trend was increasing.

Insolvency Procedures in the European Union in 1999/ 1998 [17]			
Country	**1999 (absolute value)**	**1998 (absolute value)**	**% Variation**
Austria	8.900	7.319	+ 21,6
Belgium	7.200	6.925	+ 4,0
Denmark	1.700	1.800	- 5,6
Finland	3.100	3.136	- 1,1
France	41.800	55.000	- 24,0
Germany	33.500	33.947	- 1,4
Greece	950	871	+ 9,1
Ireland	830	686	+ 21,0
Italy	12.800	15.000	- 14,7
Luxemburg	560	423	+ 32,4
Netherlands	3.800	5.031	- 24,5
Portugal	410	380	+ 7,9
Spain	770	896	- 14,1
Sweden	7.300	9.200	- 20,7
UK	46.900	37.500	+ 25,1
Total	**172.519**	**180.113**	**- 4,0**

[17] *Source*: Verband der Vereine Creditreform e.V. (Hrsg.), Insolvenzen in Europa 1999/2000: Eine Untersuchung der Creditreform Wirtschafts- und Konjunkturforschung, Neuss, 2000.