

# FINANCIAL STATEMENT ANALYSIS

## Lecture 11

### INSOLVENCY AND BUSINESS FAILURE PREDICTION

Lecturer; DR. Stephen Ndung'u

Business failure could be seen in terms of the inability of a business entity to conform itself with its strategic path of growth and development to attain its economic and financial objectives as well as legal obligations. A business entity will be a candidate of business failure if:

1. The business entity is put under statutory administration.
2. The business entity is undertaking capital reconstruction.
3. The business entity is receiving government support or/and guarantees.
4. The business entity has been put under intensive care monitoring slot by banks regulatory and monitoring unit (case of financial institutions).
5. The business entity has been subjected to loan covenants negotiations for lenders to hedge against insolvency risks.
6. The business entity has been put under statutory receivership.
7. The business entity has been forced to undergo creditors' voluntary liquidation.

Every corporate entity is expected, from the beginning to formulate corporate strategy as well as put in practice the various decision patterns that will achieve the following:

1. Define the strategic nature of business that it intends to undertake as well as the type of economic and human resources it intends to organize based on trustworthiness properly embedded in ethical culture of the environment aimed at developing the attitude of the employee to give their best in terms of productivity.
2. Produce the major policy strands as well as plan to achieve the objectives and goals.
3. Shape and reveal its objectives and goals especially, through research and development efforts.

Any corporate strategy is intended to meet the demand of the market place in order to generate profit. However, many corporate bodies fail as soon as they are established because of inappropriately formulated strategy or lack of it.

This produces corporate failure which could be traced to managerial inefficiency and ineffectiveness. A corporate body can equally fail because of its inability to appropriately apply financial resources available to it. This can create a liquidity problem which could be traced to different aspects of corporate operations. A situation where corporate managers cannot make effective resource mobilization and allocation decisions, the end result would

be low returns and subsequently inability to pay dividends to shareholders at the end of an operating period.

Very often than not, failed corporate entities can still be in existence for quite some time without the knowledge of shareholders. This could be traced to different forms of window dressing effected by management and the board with the collusion of external auditors. External auditors are well placed in a position to forewarn management on financial, accounting and management problems inherent in a firm. If they fail to do this, they have failed in their duties as external auditors.

Financial failure may take the form of bankruptcy or insolvency. Insolvency refers to where a firm is unable to meet its current obligations as and when they fall due. This happens when the current liabilities exceed the current assets. Bankruptcy on the other hand refers to where the total liabilities exceed the fair value of assets.

### **Factors that lead to business failure**

#### **1. Lack of market for the business products**

If nobody wants to buy the products (goods and services) of a business then the business will fail and close. While there are several reasons for the lack of market, the most common ones include competition, changing customer tastes, uncompetitive prices, etc.

#### **2. Poor handling of customers**

A dissatisfied customer will tell others about the negative experience while a positive customer will tell others about his/her positive experience. This therefore underpins the importance of satisfying a customer. No business can afford to survive with dissatisfied customers.

#### **3. Poor management of business stocks**

Failure to maintain the adequate quantities of stocks in the shop will drive away customers, since other competitors will always be more than ready to serve them.

#### **4. Misuse of business funds**

One very big factor that can lead to the failure of a business is the diversion of the business funds to other purposes that may not necessarily be in line with the operations of the business. This will inevitably reduce the working capital, which is the lifeline of the business.

#### **5. Poor or low quality of products for sale**

Another possible factor that may lead to the failure of a business enterprise could be poor or low quality of the products in terms of customer's expectations as well as the competing products.

#### **6. Lack of board effectiveness**

Ineffective boards suffers from limitations on skills and competence, as well as on the nonexecutive directors' (NED) ability to monitor and control senior executives effectively.

**7. Unsuitable business location**

A lot of importance is attached to the location of the business if that business is to succeed. This is particularly true if the nature of the business products is sensitive to the location of the business Vis a Vis its market.

**8. Poor management of the business**

Businesses which are poorly managed for example when they are inefficient in the use of their resources, do not keep proper records, use wrong costing and pricing methods, will inevitably make big losses and in the end fail and close up.

**9. Uncontrolled Growth**

Uncontrolled growth of the business can also cause it to fail if not handled appropriately. Proper planning must be in place even for business growth. Successful growth requires a professional management team, flexible organization, and proper systems and controls.

**10. Underestimating the Importance of Cash Flow**

Cash flow – that is the money coming into a business may have certain months that are stronger than others due to the nature of the product of the service. A business must be able to identify that they have enough cash flowing in to be able to pay bills, creditors and staff on time. If you are regularly unable to cover costs and not just in an expected or seasonal deficit period, it indicates that it is time to look at the business as a whole to identify the specific reasons for the cash flow shortage.

Cash flow is the key to success for any business that wishes to survive through a rough patch. If the management is not aware of how much ash is needed to operate a business smoothly, then the business is destined for failure.

Business entities should carry out cash flow forecasting to better understand their financial outlook. This will help them pinpoint problem areas to be addressed. The entities should also consider alternate means of financing their businesses without reaching the limits of their borrowing capacity as this has a negative impact on cash flows.

**11. Declining Sales**

One of the biggest cause of business failure is lack or poor sales. Success in business can be broadly defined by achieving increasing sales year on year. If sales begin to decline or even plateau, it is time for a business to take a fresh look at its marketing strategy. Re-establishing your product or reinforcing your message to customers could persuade them back. Having a general awareness of consumer trends can also

help a business to decide if it should change its products and services to match consumer needs.

## 12. Inexperienced or Poor Management

Behind any successful business is a strong management team, taking the lead on decisions and strategies to build staff and customer confidence. Weak or inexperienced management left to 'fire-fight' issues like staffing and creditors on a daily basis is a sign of possible business failure. When key decision makers (Directors/CEO's) are not aware of the business capabilities and importance of creating long term strategies and clear achievable goals, then such a business entity will be a candidate of failure.

To stop a poorly managed business slipping into insolvency, help should be sought from professionals such as accountants, licensed insolvency practitioners etc. who can signpost areas of improvement to focus on.

## 13. Loss of Key Customers

Relying too heavily on one or two key customers for the majority of revenue is a high risk approach to business. The circumstances of others cannot be easily controlled nor can the superior offering of your competitors if this is what proves to be the reason your customer takes their business elsewhere.

Your business should have additional sources of finance should they suffer the loss of a key customer to buffer the financial repercussion of this. Your business should also be looking to the competition to ensure you are continuing to meet the needs and expectations of those valued customers.

### **Prediction of corporate failure through ratio analysis**

Financial statements are normally used to gauge the performance of the firm and its management. From the financial statements, various ratios can be calculated to assess the current performance future prospects of the concerned firm. Some of the ratios used include current ratio, quick ratio, and working capital to total debt, total debt to total assets, profit margin to sales and return on total assets.

These ratios are used in various business failure models to predict insolvency and business failure. Business failure models can be broadly divided into two groups:

- Qualitative models
- Quantitative models

These models are commonly used by bankers to identify companies in danger of failure in advance, and then corrective action can be taken. The bankers use such information to;

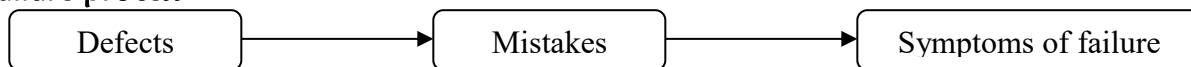
1. Decline to accept the company as a customer.

2. Encourage the company to identify its problems and take steps to rectify those problems.
3. Encourage the principals of the company to inject more capital into the business.
4. Encourage the company to seek other financing.

### Qualitative models

This category of models rests on the premise that the use of financial measures as sole indicators of organizational performance is limited. For this reason, qualitative models are based on non-accounting or qualitative variables. One of the most notable of these is the A score model attributed to Argenti (1976) which suggests that the failure process follows a predictable sequence:

#### Failure process



Defects can be divided into management weaknesses and accounting deficiencies as follows:

#### Management weaknesses:

- autocratic chief executive (8)
- failure to separate role of chairman and chief executive (4)
- passive board of directors (2)
- lack of balance of skills in management team – financial, legal, marketing, etc (4)
- weak finance director (2)
- lack of ‘management in depth’ (1)
- poor response to change (15)

#### Accounting deficiencies:

- no budgetary control (3)
- Lack of cash flow plans (3)
- Lack of costing system (3)

Each weakness/deficiency is given a mark (as shown) or given zero if the problem is not present. The total mark for defects is 45, and Argenti suggests that a mark of 10 or less is satisfactory.

If a company’s management is weak, then Argenti suggests that it will inevitably make mistakes which may not become evident in the form of symptoms for a long period of time. The failure sequence is assumed to take many years, possibly five or more. The three main mistakes likely to occur (and attached scores) are:

1. **High gearing** – a company allows gearing to rise to such a level that one unfortunate event can have disastrous consequences (15)
2. **Overtrading** – this occurs when a company expands faster than its financing is capable of supporting. The capital base can become too small and unbalanced (15)

3. **The big project** – any external/internal project, the failure of which would bring the company down (15).

The suggested pass mark for mistakes is a maximum of 15.

The final stage of the process occurs when the symptoms of failure become visible. Argenti classifies such symptoms of failure using the following categories:

1. **Financial signs** – in the A score context, these appear only towards the end of the failure process, in the last two years (4).
2. **Creative accounting** – optimistic statements are made to the public and figures are altered (inventory valued higher, depreciation lower, etc). Because of this, the outsider may not recognise any change, and failure, when it arrives, is therefore very rapid (4).
3. **Non-financial signs** – various signs include frozen management salaries, delayed capital expenditure, falling market share, rising staff turnover (3).
4. **Terminal signs** – at the end of the failure process, the financial and non-financial signs become so obvious that even the casual observer recognizes them (1).

The overall pass mark is 25. Companies scoring above this show many of the signs preceding failure and should therefore cause concern. Even if the score is less than 25, the sub-score can still be of interest. If, for example, a score over 10 is recorded in the defects section, this may be a cause for concern, or a high score in the mistakes section may suggest an incapable management. Usually, companies not at risk have fairly low scores (0–18 being common), whereas those at risk usually score well above 25 (often 35–70).

### Assignment

There has been several corporate failures that have shaken the world financial markets. Evaluate three such companies that failed in the past and highlight the signs of failure that were evident from the onset.

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