

Broken: Why business insolvency is rising

A new report released late last month by the Australian Investment and Security Commission (ASIC) reveals why Australian companies are going broke.

Compiling information from corporate insolvency specialists between 2004 and 2007, the report is a tale of management woe and illustrates the difference between those that hope for the best over those that plan for the worst. In the process, each corporate collapse rippled through the wider community with 96 percent of unsecured creditors seeing an average of 10 cents or less of the money owed.

With the economy slowing down, this report is a timely warning to everyone in business. If you are chewing cash without a strong strategy and results in place, then the financiers are unlikely to support you; they have their own problems and the level of loans against deposits is one of them. On top of that, debtor management is essential. We know from the Dunn & Bradstreet surveys and other debt recovery companies that payments are slowing down the cash flow cycle for many businesses. Debtor management is essential as is enforcing this policy across the business. Your business does not need to carry someone else's risk, particularly when the return for your good faith is less than 10 cents in the dollar.

Strategically, managers need to be on top of their numbers to identify and manage problems before they get out of hand. If you do not know what the key drivers of your business are - the things that make the difference between doing well and going under - then it's time to find out.

The top three reasons why companies fail are unlikely to surprise those in business:

1. Poor strategic management – An average of 43.3 percent of all insolvencies noted were the result of poor management. The top industry sectors most likely to fail for this reason were: transport & storage at 47.9 percent; manufacturing at 46 percent, and equal third, retail trade and property & business services at 44.5 percent.
2. Inadequate cashflow or high cash use –over 39 percent of the companies noted failed because they could not manage their cash. The top industry sectors most likely to fail for this reason were: accommodation, cafes & restaurants at 48.1 percent, agriculture at 43.9 percent; and, property & business services at 42.4 percent.
3. Trading losses – Over 33 per cent of insolvencies noted were the result of trading losses. The top industry sectors most likely to fail for this reason were: accommodation, cafes & restaurants at 47.7 percent, retail trade at 45 percent; and, wholesale trade at 41.1 percent. *Continued over the page*

Welcome to the new financial year

There are quite a few changes that came into effect on 1 July. Here's a summary to make sure that you are prepared:

- Income tax rate reductions
- The GDP adjustment used to calculate taxpayers' goods and services tax (GST) and pay as you go (PAYG) instalment amounts increases to 8% (from 7%)
- Superannuation:
 - Employers must use 'ordinary time earnings' to calculate their employees' minimum super guarantee contributions
 - Employer default funds must offer minimum levels of life insurance death cover to members
- The Medicare levy surcharge (MLS) thresholds will increase for singles from \$50,000 to \$100,000 and for those who are members of a family from \$100,000 to \$150,000.
- The definition of family in the family trust election rules will change to limit lineal descendants to children or grandchildren
- An income test has been introduced for the entrepreneurs' tax offset (ETO).
- Fuel tax credits expanded to include a range of applications (such as bull dozers, compressors, lawn mowers etc)
- Employee share scheme - the value of the discount (where it exceeds \$1,000) is included in assessable income if a taxpayer elects to be assessed upfront
- The luxury car tax rate will increase from 25% to 33%.
- The tax deductibility of contributions and gifts made by individuals and businesses to political parties, members and candidates has been removed.

Broken: why business insolvency is rising *continued*

So why it is that managers either don't see or fail to read the warning signs? The simple answer is that they are not close enough to the financial position of the business. Without the right information, many make the wrong strategic decisions. Here's our top ten list of the reasons why companies fail:

1. **Significant below budget performance** - The budget for the year looked great but actual performance is ugly.
2. **Substantial increases in fixed costs without an increase in revenues** - Fixed costs are those costs that you incur irrespective of your business activity level. When fixed costs go up they have a direct impact on your profitability. Many businesses are unaware of what their fixed costs are and as a result, neither measure nor manage them. If your fixed costs are increasing, such as leasing more space, hiring more people, buying more plant and equipment, but there is no measurable increase in your turnover and gross profit, it might tip you over.
3. **Falling gross profit margins** - Your gross profit margin is one of the key measures of business health. It is the margin between your sales, minus cost of goods sold. Every dollar you lose in gross profit is a dollar off your bottom line. For example, a business with a turnover of \$1 million and a gross profit margin of 30 per cent has \$300,000 in gross profit with which to cover operating costs. Discounting strategies will often have a major impact on gross profit levels.
4. **Funding your business primarily from debt rather than equity finance** - If your business is funded almost exclusively by debt, you're on shaky ground. Growing and start up businesses are particularly at risk.
5. **Falling sales** - If sales are falling, it is going to have a ripple through effect on your business, reducing profit contribution and inhibiting growth. Many businesses launch into marketing strategies without first understanding the problem.
6. **Delaying payment to creditors** - Your sales are good but you don't seem to have enough cash in the business to pay your creditors on time.
7. **Issuing cheques in excess of current banking facilities** - Trying to pay today's expenses with tomorrow's income.
8. **Poor financial reporting systems** - Driving your business with a blind fold over your eyes!
9. **Growing too quickly** - You're making more sales than your business can sustain.
10. **Substantial bad debts or 'dead' stock** - Customers who won't pay their accounts and stock that you can't sell.

High risk company profiles

- **Limited resources** - Consistently across the three years, over 82 percent of companies noted in the report had less than 20 employees.
- **Highest industry failure rates** - Construction topped the list in all three years representing 20 percent of all insolvencies noted. Services to business came in second highest moving from 15 percent to 13 percent across the report period. Retail came third highest at 13 percent.
- **Low asset levels** - by 2007, 87 percent of failed companies had estimated assets of \$100,000 or less. An estimated 57 percent had liabilities of approximately \$250,000.
- **Running on empty** - Around three quarters of all companies in the report had a deficiency of \$500,000 or less between their assets and liabilities.

Do something positive for your company this new financial year and talk to us about a business diagnostic and establishing a reporting framework relevant to your business.

Welcome to the new financial year *Continued*

- Families:
 - Income testing of child care benefit introduced
 - Eligibility for dependency offsets tightened
 - Introduction of a 50% Education Tax Refund on eligible educational expenses.



- The Child Care Tax Rebate for out of pocket child care expenses will increase from 30% to 50%