

*Why early action is the key
to avoiding or surviving
financial difficulties*



Thomas Westcott

BUSINESS RECOVERY & INSOLVENCY

Thomas Westcott Business Recovery LLP are a specialist firm of Insolvency Practitioners. Our head office is based in Exeter although the firm has 17 offices across the South West of England. It is headed up by Jon Mitchell, who is licenced and regulated by the ICAEW.

Company rescue options

- Company Voluntary Arrangement (CVA)
- Administration
- Pre-packs
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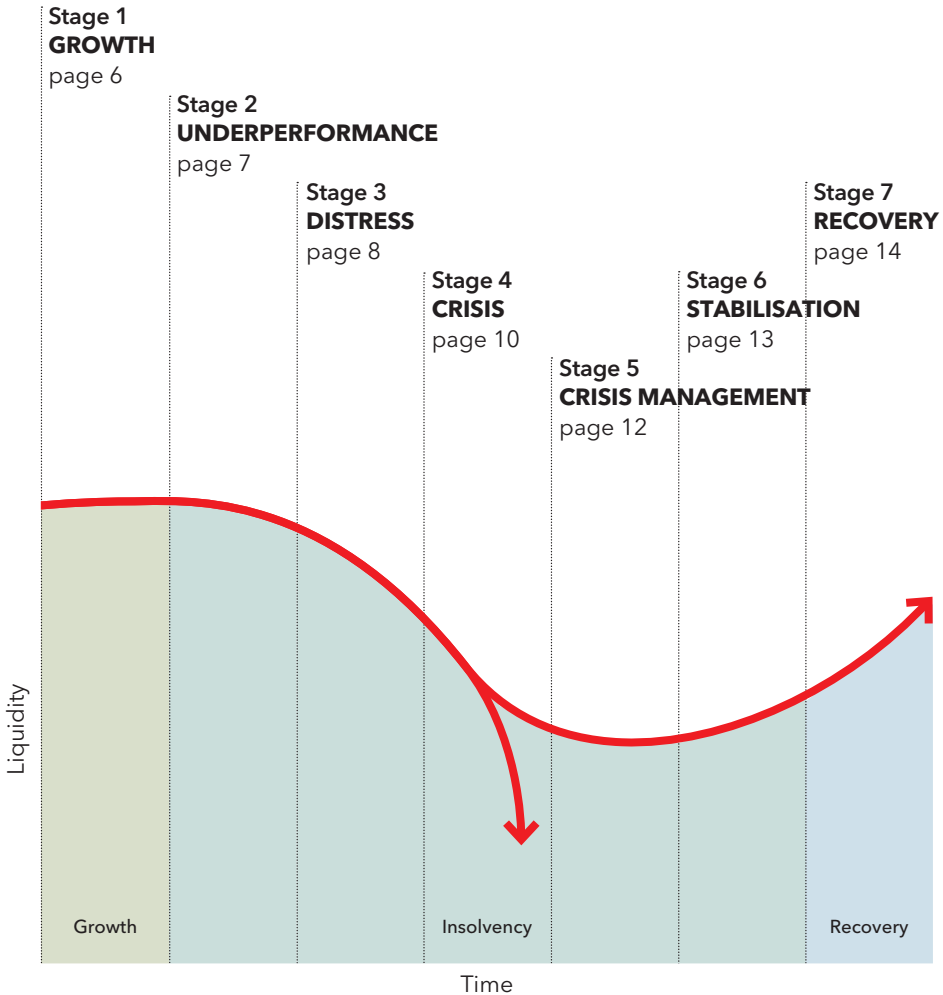
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Introduction

Most people launching a new business do so with hope and optimism. While only a handful expect their business to change the world, all hope it will succeed. But most also know that along the way they will experience challenging times. Cash rarely flows in the steady stream business owners would like. The cost of business can rise sharply and unexpectedly. This can make managing liquidity (the ability to access funds to meet outgoings) tough. The difference between businesses that survive and thrive and those that fail is how well they manage difficulties.

This guide is about how to cope with difficult situations, recognising issues early when they arise, and seeking the right advice at the right time from the right professionals. That might be a restructuring professional or a licensed insolvency practitioner (IP).

Insolvency - for businesses and individuals - remains difficult to talk about. There is still 'failure stigma' attached to even asking an IP for advice. But should this be the case?

There are many reasons for seeking advice from an IP or restructuring expert. It's important to remember that while this advice can include putting a business into a formal insolvency procedure, not every visit to an IP leads to insolvency and it can involve advice that saves businesses.

Many owners will confirm that running a business is rarely simple and businesses don't always grow in a straight line. But how can you distinguish between a temporary dip and terminal decline? Keeping an eye on what is known as the 'decline and recovery curve' (see page 3) can help.

This shows how a business in trouble finds liquidity getting steadily worse over time. There comes a point when formal insolvency is the only option.

Being aware of the dangers from a very early stage and knowing whether they are at the start of a long-term decline, or merely going through a short dip, can help owners take the early action that can save their business.

INSOLVENCY AT A GLANCE

Insolvency describes a situation when a company or individual can't pay what they owe on time, or when the value of their assets is less than the money they owe. This guide deals with insolvency in relation to companies. The law (mainly the Insolvency Act 1986) sets out formal legal processes for insolvent companies. Not every business with a debt problem ends up needing a formal solution.

An IP is appointed under the law to perform a specific role in formal insolvency procedures. There are different types of insolvency procedure for businesses (see page 11) including company voluntary arrangements (CVAs), administration, liquidation and receivership. Which route is taken depends on a combination of factors.

IPs sort out difficult situations for organisations including sole traders, businesses, partnerships, limited liability partnerships and limited companies. They offer guidance to try and rescue a business. If that's not possible, they may be appointed to handle a formal insolvency.

The work of an IP involves dealing with often-competing interests, but their main duty is to look after creditors' interests. In some cases, the IP will give advice to a company in financial difficulty before a formal process begins. On other occasions it

is possible that a company's bank might ask the IP to conduct a review of its viability. The principle in insolvency procedures is that any funds available should be distributed fairly between creditors. Creditors in the same category receive an equal percentage of what they're owed. The IP must comply with the law and can't decide who to pay first. Some creditors are classified as secured or preferential and are paid before other, unsecured (or ordinary) creditors from certain categories of assets.

Secured creditors are creditors who hold a fixed charge or security on an asset, or a debenture over a company's assets, and have the right to sell these assets to recover debt. Preferential creditors are employees owed any money. HMRC used to be preferential, but isn't any more. Everyone else is what is usually called an unsecured creditor.

The Official Receiver is a civil servant working for the Insolvency Service, dealing with investigations on compulsory liquidation cases. In some cases an IP won't be appointed and the Official Receiver will deal with all aspects of the liquidation. The Official Receiver may also deal with an individual's bankruptcy.

1. Growth

It may seem counterintuitive to think about failure at a time of growth. But there is evidence that the busiest times for IPs are in periods of economic growth and especially during the recovery from recessions. Businesses that have struggled to make sales but have survived can find themselves inundated with orders. This can lead to a loss of financial discipline and liquidity issues as cash is sucked out of the business to fulfil orders well before payment is received.

The need to have sound financial disciplines in place is well documented, but it is less obvious how decisions made as a business is thriving can lead it into trouble. The seeds for failure are often planted in good times.

So what are the signs to watch for? How can successful, growing businesses know they aren't storing up problems? One feature of successful businesses is accurate and up-to-date management information (MI). The need for this begins at launch when the founders identify their key success metrics.

To know a business is succeeding, those running it have to know the vital signs that allow them to monitor its health. For some that means daily MI, for others weekly, while for others monthly will be enough. Increasingly, monitoring is done in real time, with MI presented in a 'dashboard' that allows owners to keep an eye on the essentials. One measure to watch is the cash flow statement, along with cash in the bank. Other factors include creditor and debtor days.

A common mistake is over-trading, where a business takes orders without considering its cash flow. If suppliers demand money on terms worse than customers pay on, or there are delays being paid, each order can lead to a worse short-term position. The same can happen if currency fluctuations catch a business out and it loses money on each sale. If protections and measures aren't taken against this, a business will get into difficulties while seeming to thrive.

In these cases the gap has to be plugged, through credit, quicker payment, or another type of financial injection, such as debt or investment.

2. *Underperformance*

Early signs of underperformance can be difficult to spot. Unless there is a sudden and catastrophic disaster (a sudden loss of key staff, a new competitor with a better or cheaper product), it is possible for a business to trade apparently successfully while things go wrong under the surface.

This is where owners and managers need to keep an eye on the key success metrics they have identified. Early signs of a problem can include a lower-than-expected bank balance, surprising use of an overdraft or lower profit margins. This indicates costs of production or overheads rising faster than revenues. This can be managed for a short time if the business is aware it is happening.

If inflation forces up costs or exchange rates move to make components more expensive, action might be needed to maintain margins. Businesses with lots of debt need to watch interest rates. This is especially true now business has got used to low interest rates. Research shows that 80,000 businesses would be unable to service debts after a small interest rate rise.* That's double the number who said the same thing six months earlier.

Even owners without a grasp of key metrics often get a sense things aren't going well before they see flaws in the business. The business might feel 'under the weather'. It might be nothing serious or it might be the start of something bad.

The best advice is always ask tough questions and always act early. If problems are known, owners can act. More often it isn't simple and getting support early is better than waiting while things get worse. Liquidity or cash flow problems rarely fix themselves. Finding the cause is vital, as is understanding differences between a symptom and root cause. This is one way a licensed IP, or other trusted adviser, can help.

'Always ask tough questions and always act early'

*according to R3 (June 2017)

3. *Distress*

If no remedial action is taken, an underperforming business can quickly slip into distress, entering what is sometimes known as 'the zone of insolvency'. Remember that this is a distress situation and not yet a crisis. At this stage it is far from certain a business is bound to fail or indeed bound to enter any formal insolvency process. If owners haven't acted to restructure or resolve potential problems, this is the time to. Having entered into a situation of distress, it is more likely than not that some external agency will be required for the business to survive and get back to performing as it should.

The earlier you spot the signs of distress in a business and start to take action, the better. The higher you are up the decline curve, the more time you have and the more assets and wherewithal you have to be able to make the changes necessary to save and turn the business around.

While it is almost impossible to act too early to save a business, it is very easy to leave it too late. This is a problem compounded by business owners being reluctant to contemplate assistance from an IP.

Taking advice sooner rather than later and speaking to a licensed IP can make all the difference. If you visit the IP at the last minute, as you are defaulting on an HMRC Time to Pay arrangement or can't pay your wage bill or meet the demands of another creditor, it might be difficult for the IP to avoid a formal insolvency process.

The sooner you recognise the signs of distress and consult an IP, the more options the IP will be able to offer.

SIX SIGNS OF DISTRESS

1. Cash flow

The first sign things are going wrong is a constant lack of cash. The old adage that cash is king exists for a reason. All businesses suffer periodic dips where cash is tight. But if cash flow is continually a problem, the business is in trouble. If a business is continually spending more than it earns, unless it is deliberate and well funded (as with some tech businesses at launch) it will lead to problems.

2. High interest payments

This could indicate poor financial health and be a sign your bank or other lender is suspicious of your viability. If lenders view you as high risk, funding debt will cost more. It is also a bad sign if lenders always seek stronger personal guarantees or security against any money they lend.

3. Defaulting on bills

Everyone misses a payment or forgets a bill, but if the frequency with which it occurs increases, it suggests a business can't pay its way. This is a sign it is under funded, isn't chasing debts hard enough or is heading to liquidation. Defaults on HMRC or on other formal arrangements can be particularly damaging. It can also be bad for your reputation and that of your business.

4. Extended debtor or creditor days

Another sign of possible trouble is a rise in either debtor or creditor days. If your business has to delay payments to creditors, this can force some suppliers to cut off the supply of vital components or ingredients. Likewise if you are unable to effectively chase payment it may cause future cash flow problems. Either way, sudden changes in these numbers should be investigated to see whether they are signs of something more serious.

5. Falling margins

Ask any experienced entrepreneur and they will tell you that for long-term survival what matters are profits, not sales. As the old saying goes, turnover is vanity, profit is sanity. Falling margins suggest that costs are too high and prices or income is too low. This is not a sustainable position.

6. Unhappiness

It may sound simple, but businesses in distress are rarely happy. Owners and managers, who can sense something is wrong (but may not be sure what) get stressed and pass it on. They start cutting at random to make savings, or deploy sudden switches in strategy to try and revive things. Lots of senior people may leave in a short time. These are all signs that the business might be heading down the decline curve and that action is needed urgently to pull things back.

4. Crisis

While the word crisis is somewhat overused in modern life, a business that ignores signs of distress will eventually hit crisis point. The business may get into extreme difficulties due to a lack of liquidity that makes it impossible to meet overheads, pay staff, taxes and fines or simply finance the running of the business. Without cash, it is a fair assumption that any business will seize up, stagnate and eventually die.

By the time a situation of distress has developed into a full-blown crisis, there are fewer options open to the business owner and the IP. In general, IPs would always rather be approached when a business is further up the decline curve, with problems identified at an earlier stage and more time and resource available to help with the recovery.

However, even at a later stage, it is still better to seek advice and help from a licensed IP than to do nothing, or try to resolve things without help. Clarity of thinking is a major advantage when dealing with a crisis and the distance offered by a third party - not to mention the vast experience and technical expertise they bring - allows an IP to offer the best possible advice.

They will help a business owner consider all the possible ways out of a crisis. At this late stage it is unlikely that there will be an alternative to some kind of formal insolvency arrangement. It is better to do this voluntarily with the help of an experienced professional adviser than to face it alone.

And it is worth noting that if you seek advice from an unregulated adviser, they will then have to pass you onto a licensed IP to implement a solution. This, and the fact that IPs are regulated, is why it makes sense to go to a licensed IP directly.

'It is better, even at a late stage, to seek help and advice'

CORPORATE INSOLVENCY MEASURES

Company voluntary arrangement

A company voluntary arrangement (CVA) allows a company that owes money to enter into an arrangement with creditors to repay its debts or a percentage of them. In voluntary arrangements, the IP will initially be the nominee for the proposed arrangement. As nominee, the IP has to make sure creditors receive the information to decide whether they want to approve the arrangement. If the arrangement is approved, the IP will become the supervisor and be responsible for making sure any agreed terms are met.

Administration

An administration allows an IP to try to rescue a company or sell its assets to repay the creditors as much of what they're owed as possible. In some cases, the IP advises the directors or a major creditor on the different options available before the administrator is appointed. A pre-pack administration is an arrangement under which the sale of all or part of the company's business and assets is negotiated with a purchaser before the administrator is appointed. Soon after appointment, the administrator completes the sale. If there's been a pre-pack, the administrator will send creditors notification explaining why the pre-pack was appropriate.

Receivership

A receivership is a procedure to recover money lent to a business for a secured creditor (such as a bank). In some receivership situations the IP advises directors or the secured creditor on the different options available before the receiver is appointed.

Liquidation

In liquidations, assets are collected and sold by the IP. The proceeds are used to pay creditors, in a specific order. The courts can order compulsory liquidation (called winding-up) or directors of the company may decide to put the company into voluntary liquidation. In a compulsory liquidation, the Official Receiver initially acts as liquidator. An IP may be appointed later. Before a voluntary liquidation, an IP may help directors meet legal duties, calling meetings of shareholders and seeking a decision from creditors. If a business is solvent, it may be wound-up in a members' voluntary liquidation. An IP must still be appointed liquidator and it must be possible to pay all creditors in full, with statutory interest, if applicable.

5. *Crisis management*

There are usually several routes out of a crisis, but not all lead to the same outcome in the long term. For most business owners there are two clear options - save the business or just let it collapse.

The value of an IP is that, having faced this decision many times before, they are able to identify whether there is a realistic chance of survival, of the business recovering and succeeding over time. This is one of the key roles of the experienced IP, working with the business owners and managers, to try and identify the optimal route out of a crisis. But IPs can help to manage the crisis in the short term, even if that means taking formal proceedings.

Changing a company's culture or altering the product offering to strip out loss-making product lines can take time, but there are sometimes a number of simpler, quicker and important measures to help prevent the total collapse of a business, even if it needs to go through a formal process to emerge stronger.

Getting cost controls properly in place, insisting all purchases (however small) are signed off centrally by the managing director or finance director, chasing harder to collect outstanding debts, or agreeing new payment terms with creditors can have a quick impact and help ease an immediate crisis.

The most likely immediate priority in managing a liquidity crisis is reducing costs while maximising income. This requires difficult decisions that get to the fundamentals of the way a business organises itself and operates. This is another way in which the independent, outside voice of the IP or other adviser can make a difference.

Crisis management always involves tough decisions and often the need to use the range of insolvency measures open to the IP. These decisions are never taken lightly, but are often in the best interest of creditors, employees and the business owners.

At the point a company is technically insolvent, or there are doubts about its solvency, the directors' duties change, with them having to act in the interest of creditors rather than shareholders.

'An experienced IP will work with business owners to identify the optimal route out of crisis'

6. Stabilisation

Having acted in time and averted a crisis, an IP or other advisers can work towards a longer-term plan to put the business on a more sustainable footing. Depending on the ownership model and actions taken to date, this may mean bringing in a new senior management team.

But if crisis management is about making sure the business avoids imminent collapse, this stabilisation phase is about making sure any changes made and its operational approach create a sustainable model for all concerned parties.

In many ways this stage is similar to the launch of the business. If the right decisions are made at the start, with the right financial controls and systems being in place, it is less likely a business will end up in trouble.

This stabilisation phase is about renewal and building new foundations for a business, this time with a more financially sustainable approach.

At this point an IP should be able to help the business begin to see the other side of the crisis. Of course, if the company has gone into liquidation there will be no way back. But if the company entered a CVA it may be possible for it to return to more normal trading conditions at this point.

The same may be true of some pre-pack arrangements. Here as well, as evidence begins to gather that shows the business is beginning to get back on its feet, it may be possible to re-engage with creditors and lenders to start to get the business operating at a normal level for the future.

7. *Recovery*

Is there a better feeling for a business owner who has been through difficult times than knowing the business is back in business?

Returning to profitable and sustainable growth, in full recovery mode, is a major relief for any owner who faced the threat of collapse. Here, too, there is a role for advice and support from experienced professionals.

The primary objective now is to make sure changes made to the business, which got it through a crisis and back to recovery, are not forgotten in the rush to establish business as usual.

Unless it was a major one-off external event or an unfortunate string of events, it is highly likely the business owners or managers had some responsibility for its troubles and therefore sowed the seeds for their own downfall.

Whether that was a matter of not doing the right things or not doing things right would have been established through the crisis management and stabilisation periods.

There may still need to be some continued input from a recovery or turnaround practitioner to work with the business owner to ensure new, better habits and new, more profitable approaches to business are carried on.

FURTHER INFORMATION

ICAEW

ICAEW is a recognised professional body under the Insolvency Act 1986 and the largest regulator of insolvency practitioners in the UK. ICAEW's website includes information on how businesses can find a chartered accountant.

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The Insolvency Service

The Insolvency Service is an executive agency sponsored by the Department for Business, Energy & Industrial Strategy (BEIS) that oversees the insolvency profession and deals with some insolvencies through its Official Receiver offices. It produces a series of leaflets for those affected by insolvency issues.

0845 602 9848
insolvencydirect.bis.gov.uk ExternalOnlineForms/GeneralEnquiry.aspx
gov.uk/government/organisations/insolvency-service

ICAEW Business Advice Service

The ICAEW Business Advice Service (BAS) offers small businesses a free advice session with a qualified ICAEW Chartered Accountant. Businesses can use the BAS website, businessadviceservice.com, to find their nearest office.

The Association of Business Recovery Professionals (R3)

This is the trade association for IPs.

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