Phillipsons
Accounting|Financial Planning

Fact sheet Fact Sheet Fact sheet Fact sheet Fact sheet

Five Phases of Business Failure

Of the thousands of businesses that commence trading each year, only a few will prosper and survive in the long term. This changes very little from year to year. Based on experience, Phillipsons has identified what we call the Five Phases to Failure (5PF) and the elements that are likely to be found at each phase. Let us take a look at these phases.

1. Confident Phase (The Rise)

New business owners are full of confidence, high expectations and enthusiasm during early trading. However, with little or no business experience or knowledge of budgeting, accounting or financial management, they are unmindful of obvious pitfalls.

During this phase we can expect to see:

(i) Good trading with a reasonable demand for the product or services offered.
(ii) Increasing turnover. New business is won at the expense of more established competitors.
(iii) Suppliers offering discounts and credit to win supply contracts.
(iv) The business products and the staff are innovative and ahead of competitors.
(v) Directors are happy to sign personal obligations and guarantees.
(vi) Financial statements and budgets are prepared, although not necessarily deeply analysed.
(vii) New premises and/or plants are brought online.
(viii) Expansion is often funded on finance, because of limited capital.
(ix) Turnover growth is considered critical, but the cost of these sales is not fully understood.
(x) Regular drawings are made by owners.
(xi) Great plans for future expansion are confidently discussed.
(xii) Staff bonuses and incentives offered.

2. Consolidation Phase (The Plateau)

At the end of the 'honeymoon' period, business owners should seek advice from their accountants, who can help them to consolidate. With sound advice, some will build on their foundations of budgets and capital. They need to be disciplined, knowledgeable and pragmatic, and to instil confidence in their financiers, customers and suppliers about the strengths of the business products, service and finances.

Those that don't adapt to the new conditions can expect to see:

(i) Sales getting harder to win and increased competition.
(ii) Turnover becoming stagnant or reducing for two or more consecutive periods.
(iii) Current asset ratio weakening.
(iv) Closer attention from the bank and investors.
(v) Margins being squeezed as suppliers end their early discounts and prices have to be dropped.
(vi) Credit being harder to obtain from suppliers who require guarantees from directors.
(vii) An intermittent inability to meet all commitments - the overdraft balance increases.
(viii) Grand plans quietly downgraded to more realistic levels.
(ix) Uncertainty about the business's ability to trade profitably in the future.
(x) Preparation of financial statements becoming less regular and less rigorous.
(xi) Directors and owners becoming less enthusiastic.
(xii) Long periods being spent on managing cash flow rather than managing profit.

3. Debt Phase (The Decline)

Tough trading conditions have led to real financial problems. A steady decline will continue until the business closes or sufficient bottom line profits are earned to cover past losses.

A business in the this phase is usually characterised by:

(i) Creative accounting being used for reporting to banks and investors.
(ii) Spending is reduced on non-core activities, including marketing.
(iii) Further and greater use of ATO funds and failure to remit superannuation monies.
(iv) Further slippage in turnover, margins and profits.
(v) Quality customers are lost as they find more stable suppliers.
(vi) A need for longer term 'arrangements' with some creditors.
(vii) Some suppliers only supplying on COD basis.
(viii) Planning is done on a day-by-day survival basis.
(ix) Accountants consulted, but advice generally ignored.
(x) Internal systems and controls begin to break down.
(xi) Management's main preoccupation is demands from creditors.
(xii) Insolvent trading is now an issue for company directors.

continued on next page

continued from previous page

4. Denial Phase

Those that do not seek help, go into denial at this stage. They continue to trade, hoping that next month's trading will get better. They will not listen to reason, nor will they take rational action.

This is reflected in:

(i) A belief that existing problems can be overcome easily. Wishful thinking is the order of the day.
(ii) Greater losses are incurred, but the true extent is not acknowledged or known.
(iii) Management's time is allocated to non-core activities.
(iv) Bank and investor relations make demands to reduce their exposure.
(v) Management shows signs of complacency or arrogance.
(vi) Blame for the situation is laid on everyone else.
(vii) Preparation of any financial statements is all but abandoned.
(viii) Demands from creditors are ignored and proceedings are issued.
(ix) A refusal to recognise the existence of bad debts and redundant stock.
(x) It becomes difficult to get supply on credit or at a reasonable cost.
(xi) Management becomes unavailable to make decisions or decisions are regularly countermanded.
(xii) Current asset ratio is likely to be less than 0.5

5. The Collapse

By this time, there is little likelihood of saving the business, even under a Deed of Company Arrangement or Personal Insolvency Agreement. With luck, the appointment of a liquidator or bankruptcy trustee at this time will save the people involved from bankruptcy.

In this phase we expect to see:

(i) All working capital has been used up.
(ii) Not adhering to arrangements with the Australian Taxation Office.
(iii) Directors and proprietors looking to protect themselves.
(iv) Goodwill is lost.
(v) Bank and investors refuse further extensions.
(vi) Insufficient funds to pay wages, rent, or chattel leases.
(vii) The ATO issues Directors Penalty Notices. There are now only fourteen days left.
(viii) Administrators are appointed and expected to work miracles with virtually no working capital or reliable information.
(ix) Creditors fail to accept the director's proposal for trading on and the business is closed.
(x) Sole proprietors become bankrupt.
(xi) Directors are subject to demands from guaranteed creditors and insolvent trading claims from liquidators and end up bankrupt.
(xii) Family situations reach a crisis stage, often leading to separation and divorce.

How do you get a business off this road to failure?

Sometimes there are no answers. A business that is not profitable may survive on injections of funds, but eventually those funds will run out. Some businesses simply do not have a large enough profitable market or an appropriately formed business model to survive, regardless of any actions taken or capital invested.

To start the recovery process business owners have to take corrective action in time to make a difference. Those who make the tough decisions early generally achieve a much better outcome.

The first step ...

Engage an experienced accountant to prepare accurate and up-to-date financial statements, a realistic business plan and meaningful budgets. It may be necessary to involve an insolvency practitioner, especially if help is desirable with managing creditors, or if it is clear that the company difficulties are more than a short term cash flow problem.

Contact us

For further clarification on the above or for information on how we can help you, please contact us:

Phillipsons Accounting Services Pty Ltd
388 Raymond Street
Sale Vic. 3850
Phone: 03 5144 4566
Fax: 03 5144 5403

Phillipsons Accounting Services Pty Ltd ABN 89 103 720 190, registered office 388 Raymond Street Sale Vic 3850, has not taken into account any particular person's objectives, financial situation or needs in preparing this summary. Investors should, before acting on this information, consider the appropriateness of this information having regard to their personal objectives, financial situation or needs. We recommend that investors obtain financial advice specific to their situation before making any financial investment or insurance decision.

From time to time Phillipsons Accounting Services or its employees or agents may have an interest in or receive pecuniary and non pecuniary benefits from the services mentioned herein.