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Does your business pass the stress test?

Business owners sometimes wonder about the best time to take stock of business resilience. The answer is every time is the best time.

We look here at how to do it.

Why it matters

It's an old saying that every business will face its share of challenges, and from the pandemic onwards, the economy has provided enough challenges to test any business. Current statistics show that the ten-year survival rate for start up businesses is only 10%, demonstrating the fact that not every business makes it long term.

So how do you make sure your business is among the 10%? Knowledge is key. Every year companies fail which could have survived by taking business recovery advice at the first sign of difficulty. Knowing what to look out for, being alert to signs of stress, and knowing what to do about them, will help put you in the driving seat.

Spot the warning signs

What is a business in financial distress? The definition is simple. It's a business that can't generate sufficient revenues or income to meet its expenses and other financial obligations.

The definition may be straightforward, but spotting the signs in practice can be more difficult. It may, for example, sound counter intuitive, but business stress can start to show even when a business is busy — perhaps when sales pick up after a more rocky patch, and you need working capital to service sales before you start getting paid for them.

Act early: The top tip is to know that early intervention is always the best course of action. It's never easy to admit that a business is under stress, but delay reduces the options. Acting as soon as you have a concern should help prevent the situation becoming unmanageable.

Information: the key to survival

Accurate, up to date management information is essential. You need to know what the key metrics are for your business, and how often you need to review them. These will include things like a statement of cash flow; cash in the bank; and debtor and creditor days. Depending on the nature of your business, you may need to monitor every day, every week, or every month.

Actions to take:

- decide on the metrics that matter for your business
- keep checking whether the business is performing as you expect
- be alert to possible early warning signs, such as a bank balance lower than anticipated, or unexpected use of an overdraft.

Know the signs of stress

Remuneration issues

You can take the financial temperature of your business by looking at things like directors' remuneration or staff bonuses. If, for example, directors are unable to draw sufficient income from the business, or you haven't been in a position to pay staff bonuses, it may indicate lack of cash or working capital to pay debts as they fall due.

Plans on hold

A couple of quick questions to ask are whether the business is able to invest in new technology, recruitment, and marketing as it would want to do. Is it managing to carry out essential repairs to buildings and machinery, or having to put plans on hold? The answers to questions like these will give you an impression of whether the business is as liquid as it needs to be.

Stock levels

If stock levels are increasing, it can be a signal that incoming orders are going down. This can be an early warning sign of a worsening financial condition.

Falling profit margins

If profit margins are being squeezed, it's likely that costs are too high and prices or income too low. This could stem from factors like sudden increased competition, rising costs, or possibly problems with pricing strategy. Remedial actions include cutting costs and maximising income, and prioritising profit over turnover.

The people factor

A business that's stressed is usually staffed by people who are stressed. Directors, owners and managers may have a gut feeling that something is wrong, but not know what to do about it. This can result in pivots in business direction, rapid turnover in management or employees, and create a generally unsettled atmosphere.

Cash flow problems

Every business will sometimes find that cash is tight. But if cash flow is a recurrent problem, or if it just gets steadily worse, it's a warning sign. Cash flow problems will show up in things like:

Lack of cash reserves: If money comes in simply to go out again, it's a good indication of a cash flow problem. Businesses need a cash reserve to deal with the unexpected, like meeting unforeseen bills; or to fund equipment or staff if it took on new business.

Increased need to borrow: It's one thing needing to borrow to grow, but if debt levels seem to be going up, and the business is starting to rely on short-term loans to meet its ongoing expenses, it can be a warning that something is wrong.

Extended debtor or creditor days: As the names imply, this is about how long it takes you to get in the money due to the business; and how long it takes you to pay suppliers from the date that payment is due. If your business is repeatedly having to chase debtors for payment, or if you find yourself repeatedly needing to delay paying your creditors, it could indicate cash flow problems.

Other warning signs include:

- needing to negotiate terms with creditors
- only being able to pay the interest on debt and not the debt itself
- regularly needing to use your maximum overdraft facility
- being owed payment on invoices more than 30 days past their due date.

Cash flow problems are often caused by outstanding invoices. Where invoices remain unpaid for long periods, they can turn into bad debt, sapping the cash flow of what might otherwise be a healthy business.

> **Action tip: Risk assess business relationships**
>
> Assess the creditworthiness of customers, suppliers and other third parties, before starting a business relationship. Then make informed decisions about who you engage with; how much credit to give; conditions on which you give credit; and payment terms.

Defaulting on payments: Every business is likely to make the occasional mistake and miss a payment. What matters is how often it happens. If it starts to look like a regular pattern, it's a warning light. Check, for example, whether the business is on top of:

- pension deductions: is the business managing to pay pension deductions from employee wages to the pension provider?
- payments to HMRC.

Tax debt: Where there are cash flow problems, a debt to HMRC might seem less business-critical than, for example, timely payment of wages or supplier bills. But if a business is struggling to pay VAT, PAYE or National Insurance contributions to HMRC on time, it can be an important warning sign.

Action tip: Arrange time to pay with HMRC

Since the pandemic, HMRC has made it easier for businesses and individuals in difficulty to arrange time to pay tax debt. Subject to certain conditions, time to pay is available for all taxes, including employer's PAYE and VAT.

How to arrange time to pay: You may be able to do this online, but in some cases, a phone call is necessary. HMRC will then want to know the current financial position of the business; how you expect its finances to change in the future; and what you are doing to get its tax affairs back on track. In any arrangement, it will want to be satisfied that you can settle the bill in full as fast as possible, and keep up with repayments. It may proceed to debt enforcement procedures if monthly repayments are not adhered to.

Note that in some situations, HMRC may seek to recover unpaid tax from company directors personally.

High interest payments: The higher a bank considers the risk, the higher the interest it will charge on loans. This means that if there are doubts over your business viability, you may find the interest your bank charges is above the average market rate. Being asked for personal guarantees or security against debts can also be signs that you are considered a risk.

Increased pressure: When a business is running out of road, pressure from third parties is likely to ramp up. This could include:

- rejected borrowing applications: lenders will turn down applications for additional borrowing, extensions to overdraft or credit limits if they feel the business has got to maximum debt capacity
- action by creditors: trade accounts may be put on stop; creditors may move from simple payment reminders to threats, or commencement of recovery proceedings.

When does financial distress turn into crisis?

The answer to this is — typically — when a business does nothing. Taking timely action will always help the position.

It's important to emphasise that financial distress is not the same as crisis, and it is not inevitable that one will lead to the other. But a business repeatedly struggling with cash flow, and running up against the sort of red flag issues described above, should take them very seriously indeed. They are prime indicators that a business is moving beyond financial distress into crisis, and without appropriate remedial action, could be heading for insolvency. That's the position where a company or individual can't pay what they owe on time, or where the value of assets is less than money owed.

The special position of company directors

Company directors have a special position in law, and it is always particularly important that care is taken when trading conditions are challenging, or there's any question over company solvency.

Where a company becomes insolvent, director responsibilities change, so that creditor interests are prioritised, rather than shareholder interests. In cases of serious mismanagement, directors can be held personally liable for wrongful or fraudulent trading. This is a specialist area, where professional advice is always needed.

Next steps

If you have any concerns, please do get in touch. We can help you identify pressure points, monitor cash flow, review profitability, or put appropriate financial controls in place. We are always happy to provide advice to keep your business on track.