

Illawarra Small Business Assistance

HELPFUL HINT – COMMON WARNING SIGNS THAT A BUSINESS MAY BE IN TROUBLE

Warning signs can often fall into two clear categories – operations and accounting.

OPERATING WARNING SIGNS include:

- **Margin erosion**
- **Over-trading**
- **High gearing**
- **Under-capitalization**
- **And other examples of poor management, such as declining service standards and over investment.**

MARGIN EROSION

Continued erosion of margins indicates an inability to maintain market share and consequently remain solvent.

OVERTRADING

The business is expanding too quickly, increasing borrowings to meet its expanding cash needs. The cost of borrowings becomes a drain on cash flow hindering normal operations as well as expansion.

HIGH GEARING

Over reliance on borrowed funds results in a significant proportion of gross profits channeled towards loan capital servicing. Payback periods especially in the acquisition of fixed assets, can be crucial.

UNDER-CAPITALISATION

Many small businesses lack an adequate capital base and subsequently experience problems in financing ongoing operations.

DECLINE IN SERVICE STANDARDS

Under such circumstances sales are lost and further pressure is mounted on achieving new sales.

OVER-INVESTMENT

In some circumstances, proprietors outlay far too much capital in establishing the business with acquisition of elaborate fixed assets and hi-tec equipment far in excess of what the underlying revenue stream of the business is likely to be able to adequately service.

CHANGED BUSINESS CIRCUMSTANCES

Proprietors (especially of established businesses) can often fail to appreciate changed financial and marketing requirements. These can have a significant impact on the appearance of the profit and loss accounts, and on the balance sheet.

FINANCIAL WARNING SIGNS include:

Lack of Cash-flow forecasting

A business that fails to prepare cash-flow forecasts could inevitably be headed for trouble. The lack of a cash budget is a huge red warning light.

Difficulty in paying creditors and meeting obligations for GST and PAYG

All small businesses should closely manage their taxation obligations with regular transfer of obligations to separate bank accounts. It is unwise to rely on these funds as a source of “float” to keep cash-flow positive.

Evidence that the proprietor is continually injecting fresh capital/loans

If this is occurring and the business is not structured for recovery it may sooner or later result in an over-capitalization that will be impossible to service from internal generation of funds.

Lack of financial information

If a business can not produce regular financial information it has limited control and has little idea of how it is performing or where it is headed. Delays in production of reports and taxation based information can be a clear indicator of a business in trouble.

Declining financial ratios

Financial ratios can provide a myriad of information provided the data is reliable and the ratios are calculated and monitored in accord with industry standards. Comparative analysis with similar industry benchmarks can provide useful insights to the health of business. Declining ratios send out warning signs that should not be ignored.

ARE THERE SOLUTIONS?

A business needs to be profitable if it is to survive. It needs to be sufficiently liquid to give it scope for maneuver and keep its suppliers and other creditors content as well as produce a reasonable return on investment for the proprietor. Its overall indebtedness must be within the bounds of reasonable risk.

Despite good intentions and due to preoccupation with time pressures and daily problems many small businesses fail to give adequate attention to their financial future until severe difficulties develop. However, many common business problems can be

overcome or avoided with adoption of basic planning procedures in the areas of pricing, operations and marketing. Early identification of problem areas is crucial.

With well planned appropriate corrective action including financial reorganization and the availability of budgets and management reports from which to monitor and regulate performance, survival can most often be achieved with reasonable prospects of sustained recovery over time.

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