

Insolvency & Corporate Restructuring

May 2015

Early Signs of Financial Issues

It is easy to tell when a business runs into financial difficulty – landlords distraint, banks issue notices of intention to enforce security, leasing companies seize equipment. This is usually the stage at which business owners look for professional advice in order to restructure the business. But at this stage, it's often too late. The restructuring should be done before the bank demands and ideally before the bank even knows there is a problem. So what are the early warning signs of impending financial problems?

There is no specific test to show that a business is running into financial difficulty, but there are a number of signs that a business may display to suggest that there is a problem.

For an accountant, one of the earliest signs will relate to the company's financial reporting. The reporting will either become slow or the results will indicate problems. The following warning signs relate to accounting issues:

- Slow or poor reporting
- Difficulty obtaining accounting records
- Unrealistic annual projections and cash-flow forecasting
- Lack of budgeting
- Major discrepancies between internally prepared and audited financial statements
- Variances between actual and projected results
- Persistent operating losses

If any of these problems show up, speak to the client about the business, from its cash management to its employees. The way in which a business is managing its cash flow is another early sign of possible problems. The following warning signs relate to cash management issues:

- Overdue government remittances
- Being placed on COD with suppliers
- Payments returned NSF
- Increase in aging accounts payable
- Overdrafts
- Not making payroll

Issues with cash management will be closely related to issues with the operation of the business. Difficulties with the business can lead to inventory buildup and more desperate measures to increase business. The following warning signs relate to the operation of the business:

- Excessive buildup of receivables or inventory
- Stagnating or declining unit sales
- Lack of credit controls leading to sales to customers who are bad credit risks

- Underbidding on contracts or a sudden drop in prices
- Problems filling customer orders
- Hiring cheap labour or providing substandard workmanship
- Increasing customer complaints
- Requesting early payment of accounts receivable
- Giving unexpected discounts for early payment of accounts receivable

Ultimately, a company with financial problems will run into issues with its lenders. The following warning signs relate to issues with the lenders for the business:

- At top of its line of credit or over
- Breaching banking covenants
- Accounts transferred to special loans
- Refinancing

Refinancing is a particularly important warning sign. Looking for a new lender can be a sign that the existing lender has discovered some of the above issues. An even greater sign is if the owner is refinancing personally, such as obtaining a home equity line of credit, in order to inject further funds into the business.

Any business will occasionally run into problems with creditors. If these problems persist, they may indicate a more systemic issue with the business. The following warning signs relate to problems with the creditors of the business:

- Changing bank accounts or banking at multiple banks (in order to avoid garnishment)
- Excessive litigation
- Avoiding creditors

The interaction between management and employees can be an early sign of problems to come. In a successful business, power is shared among employees and employees have a desire to work. Employees may get an early sense of problems which leads to morale problems and departures. Alternatively, a successful business may fail because employees are

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dissatisfied and begin departing. The following warning signs relate to the relationship between management and employees:

- Single owner not delegating power
- Unwillingness of owner to hire managers or take advice from them
- Lack of staff morale
- High turnover
- Sudden departure of key employees

The final warning sign that financial problems are on the horizon is the principal's involvement with the business. In a company that is operated by one primary owner who does not delegate power, the owner losing interest is a sure sign that the business will not succeed. Alternatively, the owner may have a sense that something is wrong and may not want to invest sufficient time to turn the business around. The following warning signs relate to the personal situation of the business owner:

- Personal extravagance such as spending on boats, cars or houses
- marital breakdown
- issues with health
- dependence on drugs or alcohol
- a gambling addiction
- investing in areas that are unrelated to the core business

Recognizing the early signs of financial difficulty is more art than science. Depending on the industry and the management style, a business may succeed while exhibiting many of these signs or may fail without exhibiting any. However, if a business is exhibiting these signs, a good advisor will raise the issues with the owners so that if there is a problem, it can be dealt with early. Catching the problem early can result in a restructured business that is more successful.

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Pallett Valo LLP Insolvency & Corporate Restructuring Practice

We provide legal advice to debtors, secured and unsecured creditors, trustees and receivers in the context of proceedings under the "Bankruptcy & Insolvency Act" (BIA) and the "Companies Creditors Arrangement Act" (CCAA). Over the course of the last several years, we have guided lenders, suppliers and landlords through numerous significant CCAA proceedings.

The lawyers in our Insolvency & Corporate Restructuring Practice regularly appear in Commercial Court in Toronto and are frequently involved in litigation and other proceedings under the BIA and related provincial legislation, for the recovery of assets and setting aside of fraudulent transactions. We have proven our ability to recover assets even in the most difficult of circumstances. On the commercial side, we assist clients and Trustees/Receivers in the restructuring process, as well as the purchase and sale of businesses and assets in transactions involving insolvent entities.

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This article provides information of a general nature only and should not be relied upon as professional advice in any particular context. Contact a member of our **Insolvency & Corporate Restructuring Practice** at **905.273.3300** for more information.

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