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Towards a Financial-based View of Business Failure

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Abstract

The survival of a company finds its limit in the problems faced throughout its existence and which are likely to lead her to failure. Indeed, the company can be affected during its existence by several parameters that can compromise its durability, among which we mention: continuous or discontinuous decrease of activity, loss of business orders, debt recovery problems, imbalanced financial structure or a small capitalization, governmental tax adjustment, shareholders changes, key man death, social movement, etc. This makes business failure a transversal, dynamic and complex concept including many sides and multiple definitions.

The aim of this paper is to highlight the contribution of various studies dedicated to business failure. An in-depth analysis of the literature as well as the factors explaining distress, leads us to develop a research model of business failure based on a financial approach.

Keywords: business failure - companies' difficulties - factors of distress - financial approach of business failure - financial ratios.

Introduction

The survival of the company finds its limit in the difficulties encountered and which will automatically lead to the company's failure. The term "failure" has been subject of many discussions in several fields and is positioned at the crossroads between financial, economic and legal analysis (Guilhot, 2000). Moreover, the failure was taken up by the researchers under different terminologies: "bankruptcy", "financial distress", "mortality", etc. (Mellahi and Wilkinson, 2004).

The crisis of 1929 marked the rise of the question of failure, which was a primary field of investigation for several researchers, including Fitzpatrick (1932). This topic has attracted the interest of many researchers as well over the last seven decades (Balcaen and Ooghe, 2006). This importance is explained by the fact that investors are mainly interested in the activity of the company, its continuity over time and consequently its durability. Customers, suppliers, creditors and employees are all concerned with the future potential of the company (Weitzel and Jonsson 1989, Daubie and Meskens 2002). As a result, its disappearance is likely to lead to a drama, both microeconomic and macroeconomic for all its partners (Charest et al., 1990).

There is a confusion about the sharing of causes and consequences, as the cause of financial failure being strategic in nature (Foster, 1986). In the same vein, Argenti (1976), Laitinen (1991) and Thornhill and Amit (2003), consider that the failure differs from one company to another (depending on the sector of activity, age and size). Moreover, a small firm presents higher risk of default while the big one is self-sustaining (Edwards, 1975).

In addition, marginal companies, characterized by sales volumes that do not cover all costs, will disappear (Michaux, 1978). We are talking about financial magnitudes that are likely to threaten the sustainability of the company. Malinvaud (1981) argues that access to funding is conditioned by maintaining solvency. In this case, the company will encounter difficulties in case of inability to repay its creditors. Mélitz and Bordes (1991) discuss the subject of liquidity, in the sense that the firm is threatened by bankruptcy because of the gap between costs and incomes.

The failure also depends on the different national legal frameworks (Hautcoeur and Levratto, 2007). As an illustration, the Moroccan legislator associates the failure of the company (or bankruptcy) to its cessation of payment, which is a harbinger of distress.

We propose to help improve the understanding of the subject by guiding our discussion in order to answer the following two questions:

-How does previous research' treat the concept of failure and what are its explanatory factors?

-Taking into consideration the informational quality of the accounting data, how can the failure be explained according to the financial approach?

In order to answer these questions, a first part will be dedicated to an analysis of the literature by exposing the panoply of concepts and notions likely to better frame the subject of the failure. Then we will expose the process leading to distress. At the second part, we will focus our research on explaining the causes of the default regarding the financial parameters. Finally, we propose to contribute to improve the subject's understanding according to a hypothetical-deductive approach based on the theoretical premises already advanced, in order to present a convenient model for our research.

1. Definitions of Business failure and its causes

Business failure is a cross-cutting, dynamic and complex concept with many facets and multiple definitions (Levratto, 2012). We will try, in this part, to define it from different angles and to study its various aspects.

1.1 Business failure definition

Failure has no single definition (Zopounidis, 1995). Khelil (2010) argues that a failure which is read with a theory is not necessarily a failure if read with another theoretical grid.

According to Fitzpatrick (1932), the failure has aroused the interest of researchers since the crisis of 1929, making it a research field in its own right. Thus, this phenomenon has been analyzed in different ways and by different disciplines (Guilhot, 2000).

The distress reflects the situation of the company in difficulty, which, according to Casta and Zerbib (1979), includes a legal pillar (the bankruptcy procedure following the filing of a balance sheet related to an insolvency situation), an economic pillar (lack of profitability translated by a negative added value), and a financial pillar (cash flow problem resulting from an inability to honor the financial commitments).

1.1.1 *Legal failure*

According to Hart (2000), there are three main reasons for a bankruptcy law existence:

-Valuing properly the company that will be restructured, sold, closed and/or liquidated;

-Encourage the debtor to honor its commitments to its creditors;

-Penalize the management fault by subordinating the payment of the shareholders of the defaulting company to that of the other creditors.

According to Martinez (2003), the fragility of the company comes after the conclusion of a debt restructuring agreement. In addition, legal failure depends on the legislative framework of the country to which the enterprise is subject. Indeed, as far as the Moroccan case is concerned, law governs the difficulties of the companies (Book 5 of the Law n °15-95 of the Code of trade).

The law of companies in difficulty knows a predominance of the economic logic rather than the legal one, and this to find solutions and compromises between the different contradictory interests. On the one hand, it privileges the creditors of the company because they are the engine of the economy, on the other hand it avoids neglecting the rights of the company in distress to keep jobs.

1.1.2 *Economical failure*

According to Zopounidis (1995), economic failure emerges when the productive apparatus is absent or ineffective, or when the products manufactured by the company are difficult to sell on the marketplace, or when the company no longer contributes to the economic and social development, fighting unemployment, or improving individuals' quality of life, and increasing their purchasing power.

That said, Crucifix and Derni (1992) argue that the role of the company is to create profitability and sufficient liquidity.

Liou and Smith (2007) define the company in distress by its low profitability due to the decline in its turnover. Ooghe and Van Wymeersh (1996) state that the company is in difficulty when its economic objectives are no longer achieved, taking into account the social obstacles it faces. According to Van Wymeersch (1996), the continuity of the enterprise and thus its survival is strongly correlated with the remuneration offered to the production elements. But the real dilemma is whether this added value can be used to fund efficient inputs that are used properly.

1.1.3 *Financial failure*

Modigliani and Miller (1959) consider that companies that are likely to bear a large debt burden are the least exposed to default thanks to their performance. According to Malecot (1991), financial failure arises when the operating activities do not make it possible to deal with the liabilities due through assets held. Baldwin and Mason (1983), for their part, emphasize the company's inability to cope with its financial constraints.

According to Crucifix and Derni (1992), when the activity of the company goes slow, it threatens the profitability of the enterprise. John (1993) has shown that financial distress is the result of the difference between the liability of the firm and its available assets.

The default is the result of insufficient liquidity combined with negative profitability. Ooghe and Van Wymeersh (1990) define the default as financial distress resulting from insufficient cash flows to cover the various commitments of the company. Differentiating between four scenarios that can be faced by any company during its life cycle:

- Healthy: profitable and liquid business;
- Transient disease: profitable and non-liquid business;
- Chronic disease: unprofitable and liquid business;
- Eminent end: unprofitable and non-liquid business.

These two researchers confirm that the lack of added value and the heaviness of the structural costs are the initiators of lack of profitability. According to Platt and Platt (2002), financial failure owes to several payment incidents, following one another, due to the absence of a solution to honor the payment of debts.

1.2 Business failure causes

Several researchers have investigated the causes and symptoms of failure, such as Argenti, (1976); Koenig, (1985); Ooghe and Van Wymeersch, (1986); Marco, (1989); Laitinen, (1991); Liefhooghe, (1997); Ooghe and Waeyaert 2004; Ooghe and De Prijcker, (2006), but none of them considered failure as a chained process that deserves in-depth study. Moreover, several shortcomings have been raised by Crutzen and Van Caillie, including the dissociation of organizational and financial approaches when they are supposed to be complementary. There is also a lack of theory that is really based on empirical studies, since the studies carried out concern a non-representative sample (of a particular size or specific to a sector of activity) that cannot be generalized. Moreover, the notion of time used is not stable, which decreases the credibility of the theory. And finally, there is a lack of process unifying the causes and trajectories that failing companies can take.

It is therefore understandable that this change of state leading to bankruptcy is not a sudden phenomenon but rather the result of a long and complex process due to multiple factors (Luoma and Laitinen, 1991).

The unifying model of Crutzen and Van Caillie (2006) overcomes the previous literature review gaps, bringing the following novelties: first, it combines the qualitative and financial approaches, which were previously separate. Secondly, this theoretical model was developed following an analysis of 50 companies in difficulty, which makes it applicable to any class of companies. Thirdly, it is able to trace the different trajectories that the failing companies can follow, and therefore an excellent model of prediction.

The analysis of the company's difficulties is based on two complementary approaches, namely the Darwinist approach and the behavioral approach of Wit and Meyer (2010):

- The behaviorist approach centralizes the management of the company on its organization, including the leader, its profile, its management style, its motivations and ambitions.

- The Darwinist approach emphasizes the environment with which the company interacts and impacts its existence and the decisions it makes.

The author of the model decided to use these two complementary approaches, motivated by the statements of Keasey and Watson (1987), followed by Hambrick and D'aveni (1988). This makes it possible to draw the company as a restricted portfolio of different human resources, intangible, financial and technical, which will be structured according to the vision of the leader and its background, and to which will be imposed, by its external environment, constraints of availability, quality and volume that are not controllable. Obviously, a management that does not take into account the impact of the external environment will be deficient, and therefore negatively impact the policies of the structure (Nathalie Claveau, Muriel Perez and Thierry Serboff, 2016).

To recognize the symptoms of financial failure, we must distinguish between several interconnected signs:

- Decrease in turnover due to the deterioration of the factors of production

- This decline in the company's position leads to a decrease in profitability and competitiveness (Marco 1989). This is reflected in bearish financial indicators and a decrease in market share. Third parties notice the first signals of failure and adopt fearful defensive behavior towards it. Suppliers require immediate payment and banks require additional collateral for any additional credit.

- This in turn causes a shortage of cash flow and therefore a lack of self-financing

- This has repercussions on the cash flow of the company, which lacks liquidity, technical resources that are under investment, and staff lacking motivation

- In order to strengthen its position, management has to find new capital, which will cost it dearly considering their low position. In the absence of shareholders interested in raising funds, the company resorts to the bank which is becoming more and more demanding, and financial burdens are weighing more heavily on society (Marco 1989). All in all, solvency deteriorates and leaders under pressure take the wrong decisions.

- Working capital decreases, the need for working capital increases, and the cash is deteriorating more and more.

To conclude, any business has a bankruptcy profile if the following items are grouped together:

• Insufficient and poorly managed resources

• Illiquidity and insolvency at the financial level

• Low strategic position in the market.

It should be noted that this grid of reading is subjective, by classifying the various non-exhaustive variables according to the researcher's vision, which confirms that his analysis brings a static, arbitrary and reductive view of the life of the company as conferred by Melese (1979).

2. Factors of business failure according to the financial approach

The analysis of the accounting and financial information makes it possible to make a judgment about the financial health of the company and the continuity of its activity. Several indicators have attracted the interest of researchers, including financial structure, profitability, solvency, liquidity and indebtedness.

2.1 Rentability

According to Keasy and Mc Guinness (1990), profitability and efficiency are the most significant indices of the failure for Anglo-Saxon industrial firms. In addition, companies with bearish earnings are likely to face financial difficulties. They also added that strong profitability can preserve from the risk of default, and that low profitability of assets makes banks cautious about granting credits. This is in line with the bank's willingness to participate in financing the company if growth is achieved. Sung, Chang and Lee (1999) confirm this, since profitability reassures banks about the company's ability to repay its loans over the medium term. Tirapat and Nittayagasetwat (1999), Atiya (2001) discuss the correlation between the probability of default of a firm and the profitability of its actions. They believe that a positive equity return is a good index for the financial markets, and for the forecast of default. Financial profitability challenges the overall result with market capitalization according to Mensah (1984). Whereas economic profitability links the economic result to the total assets, the committed capital and the fixed assets (Altman, 1968, Taffler, 1982, Flagg et al, 1991, Michalopoulos et al, 1993, Liou and Smith, 2007).

2.2 Debt repayment capacity and financial charges' coverage

The financial autonomy of the companies is easily impacted by the weight of the debts and the related financial burdens. This has repercussions on the repayment capacity, which results from successive payment incidents. To avoid this scenario, creditors require an additional risk premium. To judge the repayment capacity of a company, several authors are interested in the cash flow generated. For example, Hol and Al. (2002) stress that default is the typical situation where the value of cashflow no longer makes it possible to cover debts. In addition, Liang and Wu (2003) consider that an inefficient cashflow reflects a state of failure. It is clear that among the criteria for predicting bankruptcy and default, repayment capacity is a key indicator. In this context, Casey and Bartczak (1985) concluded that the cashflow provides significant information on the prediction of default and makes it possible to decide between failing and healthy businesses. As for the repayment of credits, the authors have agreed that cashflow alone, must be able to cover commitments, including loans contracted. Regarding significant indicators for the granting of credit, in 2005 Fedhila and Ben diab conducted a study based on 66 loan applications filed with six Tunisian banks. They concluded that the cashflow has no impact on the bank's decision on the agreement or rejection of the credit. And that the latter is based only on the summary statements, namely balance sheet and income statement.

2.3 Liquidity

Liquidity is defined according to Pompe and Belderbeek (2005), Refait (2004), Jones and Hensher (2007), Lin (2009) as the ability of a company to repay its short-term debt. This translates into the ability of the company's assets to create cash to meet current liabilities. Research by Chralambous et al (2000) concludes that liquidity is a preferred indicator for predicting default within one or two years, as illiquidity leads to long-term insolvency, which leads to remarkable downside profitability. To distinguish failing companies, one refers to cash flow. A normal business may suffer from temporary negative cash flow, which it can overcome and will not threaten the continuity of its business. On the other hand, a failing company will see its negative cash flow continuously, following a remarkable deficit of long-term resources. To remedy this, companies resort to banks, which generally prefer to grant short-term loans to have more control over the business, rather than providing long-term loans that will be used more to carry out an investment plan (Hunter and Isachenkova, 2001). An increased need for working capital is the result of a growth of the customer and inventory item with regard to the supplier item. An increase in trade receivables is certainly the result of the dynamism of the sales force but can also call into question customer default. As for the increase in the stock, it reflects a disproportion between production and sales, resulting from poor planning of market demand (Blazy et al, 1993). Indeed, the cash offsetting depends on both the customer recovery period, storage period and supplier payment period. Thus, the lack of operating cash flow is only the consequence of a shift in physical and financial flows related to the operation.

2.4 Solvency

A company is considered solvent when its assets are sufficient to pay its debts. Moreover, Helal (1994) has mentioned that this is a very interesting signal for creditors, since a payment default can reflect a financial difficulty, can hide a default and may lead to the disappearance of the company. This explains why Pindado and Rodrigues (2001) emphasize the importance of equity in the financial structure of the company. Indeed, the higher the equity ratio, the lower the probability of default. Working capital is considered as the indicator of the financial equilibrium of the company and represents the margin of safety available to the company and which allows it to be autonomous with regard to the creditors. In this sense, a rebalancing and adjustment of this safety margin must be carried out at all times taking into consideration the various economic risks. Given that working capital has a significant impact on profitability and risk. The financial equilibrium assumes that stable resources must cover long-term jobs, and short-term resources must cover the current assets, thus guaranteeing the firm a stable financial health. Any imbalance in this distribution, generates a liquidity weakness combined with high payability, which may lead the company to sell its real estate. To avoid this scenario, Blazy and Al (1993) emphasize the importance of positive working capital to ensure the survival of the company. They also add that banks are looking at the evolution of working capital over time to judge the financial policy of the company. In case this margin of safety is insufficient, the company will be obliged to contract credits to finance its investments.

2.5 Indebtedness

Modigliani and Miller (1963) have long developed the interest of debt, which generates a positive leverage when the operating profits exceed the interest charges and generates a club effect the opposite case. These authors also mentioned the deductibility of interest which constitutes a tax advantage encouraging indebtedness. However, rising debt increases the likelihood of default, prompting creditors to require a higher rate of pay to offset bankruptcy costs where appropriate. Faced with a failing company, the creditor has the choice between granting new loans in order to recover his old debts with a higher interest rate (and therefore an additional charge to the company), or the refusal if the insolvency of the company seems obvious to him. Unlike what has been said by Modigliani and Miller (1963), several researchers (Altman, 1968, 1984, Casta and Zerbib, 1979) have pointed the link between rising indebtedness and weak enterprise. As soon as the company no longer controls its debts, the risk of bankruptcy increases and may even lead her to a judicial reorganization proceeding (Beaver, 1966, Altman, 1968). Hence, Titman and Opler (1994) consider the debt as a source of financial stress capable of threatening the company. Increasingly high debt is raising doubts in the minds of the company's third party and compromises its ability to repay its commitments. Not surprisingly, a balance sheet consisting mainly of debts can only weaken the company in question. This is why Artus (1992) emphasizes the advantage of equity financing, unlike debt that can threaten corporate repayment and under-optimizes financing choices. If we go back a little bit in time, we will find that companies were heavily indebted to the 70s, following inflation and economic growth. A decade later, these same companies regretted their choice, crises and oil shocks weighed heavily on indebted companies, and threatened their ability to repay. Thus, Blasy and Al (1993) emphasize that a long-term investment must be financed by long-term financing. Indeed, two researches were carried out whose results are extremely intriguing. If Bunn and Redwood (2003) estimate from their study of a sample of UK firms covering the period 1991-2001, that debt impacts the financial strength of the firm. On the other hand, Pompe and Belderbeek (2004) refute the causal link between the debt and the financial situation and consider that the default is caused by the decline in activity and the lack of profitability. In conclusion, Hunter and Isachenkova (2002) spoke of the double debt sword, which the company derives benefits in times of economic growth; and harvests the damage in the event of recession.

3. Towards the construction of a research model of business failure

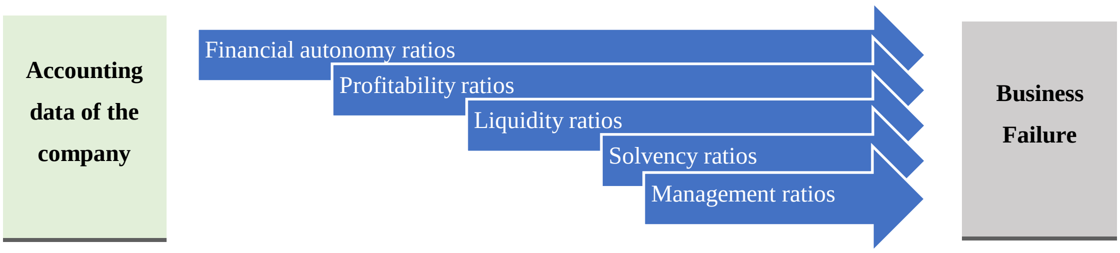
According to our readings, financial failure occurs when the company is unable to meet its commitments. This failure has been examined by various models, among which we mention the best-known ones, notably those of Fitzpatrick (1932), Beaver (1966) and Altman (1968). Given the insufficiency or lack of qualitative and organizational data, these researchers consider that the figures provided by companies at the level of their summary reports reflect a faithful image of their health's situation. They thus emphasized the definition of the financial ratios likely to explain the failure (or not) of a company.

As a result, the construction of our research model was selected based on:

- The use of the most cited financial ratios in literature: Beaver (1966), Altman (1966), Ohlson (1980), Elam (1975), Mensah (1983), Deakin (1972), Grammatikos (1985) .
- Taking into account the basic ratios of the financial analysis presenting a significant informational content and offering a better capacity of interpretation of the accounting data.

Thus, we have retained a direct causal link between the explanatory variables that are the different financial factors cited in the literature and the business failure that is the dependent variable, or to explain (see figure 1 below).

Figure 1: Research model of business failure based on financial approach



Source :(own elaboration

Conclusion

The number of entrepreneurial failures is growing from one year to another. The durability of the company is becoming problematic, thus impacting the international economic landscape characterised by the tough competition (Sqalli, 2019). On the one hand, Eklund, Levratto and Ramello (2018) consider that the multitude of disappearances of companies are likely to dissuade potential entrepreneurs and on the other hand, to negatively impact access to different financing resources.

Given the tightening of payment terms and the increasingly competitive environment, the company continues its quest for bank credits to undertake its activity in good cash flow conditions and meet its various commitments.

However, regarding the Moroccan context and while examining the Bank balance sheets, we note that the outstanding debts held with the Banks present a risk rate of 10.3% in 2017. In accordance with the definition of Bank Al Maghreb (Central Bank of Morocco), these are receivables that present risks of total or partial non-recovery in regarding the deterioration of the immediate and/or future repayment capacity of the counterparty. These receivables are covered by the banks with provisions of 73% (according to the annual report on banking supervision for the 2017 financial year).

Thus, we will try in our future research to focus on financial failure which is already a warning signal, since several cases face solvency problems regarding their various partners, mainly financial (credit institutions), thereby announcing the failure to pay. This new research track will be oriented towards the case of Moroccan companies having opted for bank indebtedness.

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