Collapse of Carillion and the lessons to be learned

Ben Cussons, Business Advisory Manager and member of the Construction Group at Scrutton Bland LLP, looks at some of the ways to check on the financial stability of your construction contractor.

The recent collapse of Carillion serves as a fresh reminder of the pitfalls that a combination of high risk and low margin within the construction industry can present.

Carillion are only the latest in a long line of major contractors to be caught out by this combination, the full extent of which is yet to be felt. Many suppliers both in the UK and beyond will continue to feel the effect of Carillion going into liquidation. This will in time work its way down the supply chain, bringing about further business failures.

Care should be taken when dealing with new significant customers and suppliers as, irrespective of size, they can all fall foul of overtrading. The risk of a valued customer or supplier failing is something which has a significant effect on any business.

A company's size and reputation does not make it immune from trading difficulties, as Carillion proves, and there are some preliminary steps you can take to gain comfort and to reduce exposure to such risk.

Suppliers of goods to the construction industry may be able to insure their sales ledger against any potential bad debts and, providing that the goods have not been used, there is a possibility that they may even be recovered and brought back into stock. If insurers are not prepared to provide cover for a specific customer's debt this may provide an early indication that they may be facing some liquidity issues.

Those supplying skilled labour may need to delve a little further to gain an understanding of the state of affairs as insurance is unlikely to be available to safeguard against this element of supply.

The use of credit reference agencies can give you useful information as to the creditworthiness of incorporated businesses. The information available on public record at Companies House is another good place to research and can help you obtain some background as to the financial state of affairs of the company in question.

Ben Cussons, Business Advisory Manager and member of the Construction Group at Scrutton Bland LLP. Picture: CONTRIBUTED

The filed accounts for small companies will not tell you a great deal in many cases. However the composition of the balance sheet may give some clues as to the underlying picture of what the company has behind it.

A positive net asset position is considered a must and by digging into the previous few years of filed accounts you can track the movement in net asset figures over time. It is also important to understand how the net asset values are made up as a positive number does not necessarily mean all is well. For example, a high level of intangible assets or rapidly increasing work in progress might prompt further questions.

If full accounts are filed there is a great deal of information available to you. There are a few areas to consider and ratios you can calculate that can give some initial insight:

A company's size and reputation does not make it immune from trading difficulties. Picture: ISTOCK / GETTY IMAGES

- The gross profit margin is important as it gives an indication as to the ability of the business to withstand problems. Those with lower margins have less scope for variation and are vulnerable, leaving the business less able to absorb problems such as overruns or delayed payments.

- The "creditor days" ratio calculates, on average, how many months a business takes to pay its suppliers (by dividing trade creditors by cost of sales and multiplying by 12). It would not be unreasonable to expect that an invoice would be paid within 30 to 60 days of receipt. Therefore a "creditor days" ratio showing a greater amount may indicate that the business is struggling with cash and failing to meet its obligations to suppliers as they fall due.

- If the company is generating a profit each year but the retained reserves are not increasing, this may indicate that the cash generated from trading is being withdrawn from the business or is funding high borrowings, leaving little surplus to cope with any shortfalls as they occur.

As in all business it is important to be certain of who you are engaging with. If you have any concerns your accountants can assist you in undertaking some due diligence checks on the published accounts which may well prove to be invaluable and help prevent problems in the long run.

For more information or help with construction industry issues, contact Ben Cussons, Business Advisory Manager on ben.cussons@scruttonbland.co.uk or 01473 267000.