

# **Causes of Failure in Bankruptcy and Compulsory Liquidation**

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# **Section 1: Executive Summary**

## **1.1 Introduction**

This report looks at the causes of failure in bankruptcy and compulsory liquidation cases, collectively in England & Wales, over a two-year period. It focuses on three key areas:

- The primary causes of failure
- The profile of insolvents with the same primary cause of failure
- The secondary and tertiary causes of failure

The aim of this analysis was to ascertain the reasons that lead to an insolvent entering bankruptcy or compulsory liquidation proceedings, and whether any conclusions could be drawn regarding causes of failure and the profile of insolvents. This report will add to the evidence base for future policy decisions. Additionally, the information will assist in determining the scope for further research into insolvency.

## 1.2 Key Findings

### Bankruptcy

- The main causes of failure were 'living beyond the bankrupt's means', a business failure and unplanned changes to the bankrupt's circumstances.
- Unplanned changes to the bankrupt's circumstances include 'life events', such as illness, an accident or a relationship breakdown, and the loss or reduction of income (either of the bankrupt or his/her household).
- The most common cause of failure in bankruptcy over the study period was 'living beyond the bankrupt's means'.
- 'Living beyond the bankrupt's means' was cited as a cause of failure in 63% and 70% of bankruptcy cases in 2003/4 and 2004/5 respectively, and was the primary cause in 42% and 48% of cases in 2003/4 and 2004/5 respectively.
- Unplanned changes to the bankrupt's circumstances were cited as a cause of failure in 34% and 41% of bankruptcy cases in 2003/4 and 2004/5 respectively, and were the primary cause in 20% and 27% of cases in 2003/4 and 2004/5 respectively.
- The loss of, or significant reduction in, the bankrupt's income was the most common unplanned change to a bankrupt's circumstances that was cited as the primary cause of failure. This was primarily due to loss of employment.
- A business failure was cited as a cause of failure in 31% and 21% of bankruptcy cases in 2003/4 and 2004/5 respectively, and was the primary cause of failure in 27% and 19% of cases in 2003/4 and 2004/5 respectively.
- In 2003/4, the main reason why 'business failure' was the primary cause of failure in bankruptcy was due to the bankrupt's failure to deal with tax affairs, whereas in 2004/5, the main reason why a business failure was the primary cause of failure in bankruptcy was due to the failure of a new venture, expansion or acquisition, i.e. a speculative business investment.
- The bankrupts' gender, age, petition type and home-ownership status were significantly associated with primary cause of failure. Notably, there are more men, fewer young bankrupts (aged 18 – 29), more creditor petition bankruptcies and more bankrupts owning homes than expected associated with a primary cause of failure due to a business failure.

## 1.2 Key Findings (continued)

### Bankruptcy (continued)

- In contrast, there are more women, more young bankrupts (aged 18 – 29), more debtor petition bankruptcies and fewer bankrupts owning homes than expected associated with a primary cause of failure of living beyond a bankrupt's means.
- A primary cause of failure due to a business failure appears to be associated with higher amounts of debt, and a primary cause of failure due to loss of income appears to be associated with lower levels of debt.

### Compulsory liquidation

- The main causes of failure for companies in compulsory liquidation were loss of market, failure to deal with tax affairs and 'other management failures'.
- Loss of market was cited as a cause of failure in 51% and 47% of compulsory liquidation cases in 2003/4 and 2004/5 respectively, and was the primary cause in just under 30% of cases in both 2003/4 and 2004/5.
- Failure to deal with tax affairs was cited as a cause of failure in 31% and 28% of compulsory liquidation cases in 2003/4 and 2004/5 respectively, and was the primary cause of failure in just over 20% of cases in both 2003/4 and 2004/5.
- 'Other management failures' were cited as a cause of failure in 51% and 47% of compulsory liquidation cases in 2003/4 and 2004/5 respectively, and the primary cause of failure in just under 30% of cases in both 2003/4 and 2004/5. The management failures were varied, but the most common were under-capitalisation, over-optimism, excessive overheads (including remuneration) and lack of, or poor, planning.
- There were significant associations between the primary cause of failure and the length of time a company had been trading and the petitioner in the case (Crown or other).
- Loss of market as a primary cause of failure became relatively frequent the longer a company had traded.
- For companies trading at least 5 years, failure to deal with tax affairs as a primary cause of failure was less common than expected.

## **1.2 Key Findings (continued)**

### Compulsory liquidation (continued)

- 'Other management failure' was a more common primary cause of failure amongst companies that had traded for less than 2 years and as the trading period increased, relatively fewer failures were attributed to this cause than expected.
- There were more failures than expected due to a failure to deal with tax affairs where the Crown was the petitioner.

## 1.3 Methodology

Details of the causes of failure, together with profiling information, on bankruptcy and compulsory liquidation cases have been extracted from reports to creditors for the periods 2003/4<sup>1</sup> and 2004/5.

The Official Receiver issues a report to creditors in every bankruptcy and compulsory liquidation case. It is primarily based on information provided by the insolvent and almost all reports to creditors are issued within 12 weeks of the making of the insolvency order<sup>2</sup>.

The Insolvency Service has undertaken a case sampling exercise of reports to creditors. The samples were drawn from reports to creditors issued in respect of bankruptcy orders and winding-up orders made in 2003/4 and 2004/5.

The following information was extracted from the reports to creditors on bankruptcy cases:

- Causes of failure
- Age and gender of bankrupt
- Petition type
- Homeownership
- Asset and liability details

The following information was extracted from the reports to creditors on compulsory liquidation cases:

- Causes of failure
- Length of trading period
- Business of company
- Number of directors
- Petitioner
- Asset and liability details

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<sup>1</sup> The period 2003/4 refers to the year ended 31 March 2004

<sup>2</sup> Internal statistics maintained by The Insolvency Service show that 99.7% of bankruptcy and 99.1% of company reports to creditors were issued within 12 weeks of the making of the order in 2003/4. Similarly, in 2004/5, 98.9% of bankruptcy and 95.5% of company reports to creditors were issued within 12 weeks of the making of the order.

### 1.3 Methodology (continued)

A total of 1,000 reports to creditors were randomly sampled, stratified on a regional basis for each year. In some instances, the reports to creditors did not contain cause of failure and profiling information because, for example, the bankrupt/director had not co-operated with the Official Receiver. Details of the population sizes and the number of reports to creditors where cause of failure and profiling information was available are shown at Table 1.

	<b>2003/4</b>	<b>2004/5</b>
<b>Bankruptcies</b>		
Total number of bankruptcy orders <sup>3</sup>	29,633	37,562
Size of bankruptcy sample where cause of failure and profiling information was available	1,000	1,000
<b>Companies</b>		
Total number of winding-up orders <sup>3</sup>	4,857	4,477
Size of compulsory liquidation sample where information was available on:		
The cause of failure	919	861
The length of trading	599	352
The business of the company	919	861
The number of directors	908	855
The petitioner	919	861
The assets and liabilities	915	861

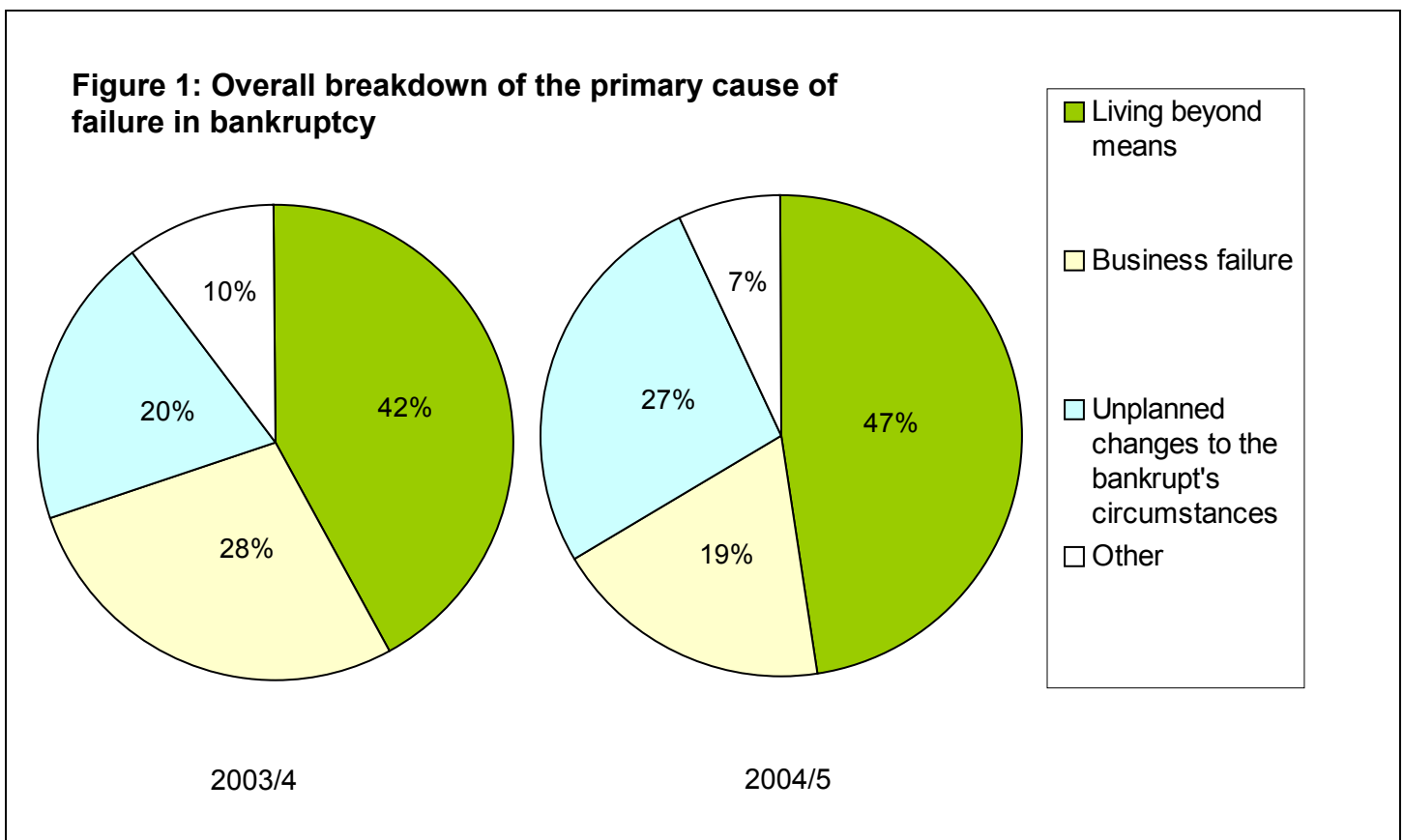
A detailed breakdown of the causes of failure identified is contained at Appendix 1.

<sup>3</sup> Based on statistics published by The Insolvency Service (previously the DTI Statistics Directorate) (not seasonally adjusted)

## Section 2: Causes of Failure in Bankruptcy

### 2.1 Primary Causes of Failure (bankruptcy)

- In broad terms, the main causes of failure over the study period were living beyond the bankrupt's means, a business failure and unplanned changes to the bankrupt's circumstances (see Figure 1). Unplanned changes to the bankrupt's circumstances include 'life events', such as illness, an accident or a relationship breakdown, and the loss or reduction of income (either of the bankrupt or his/her household).
- The most common primary cause of failure in bankruptcy over the study period was 'living beyond the bankrupt's means' (see Figure 1). This was the primary cause of insolvency in 42% of bankruptcy cases in 2003/4 and 47% of bankruptcy cases in 2004/5.



- The failure of a business on a self-employed basis became a less common primary cause of failure over the study period. This was the primary cause of failure in 28% of cases in 2003/4, compared to 19% of cases in 2004/5 (see Figure 1).

## 2.1 Primary Causes of Failure (bankruptcy) (continued)

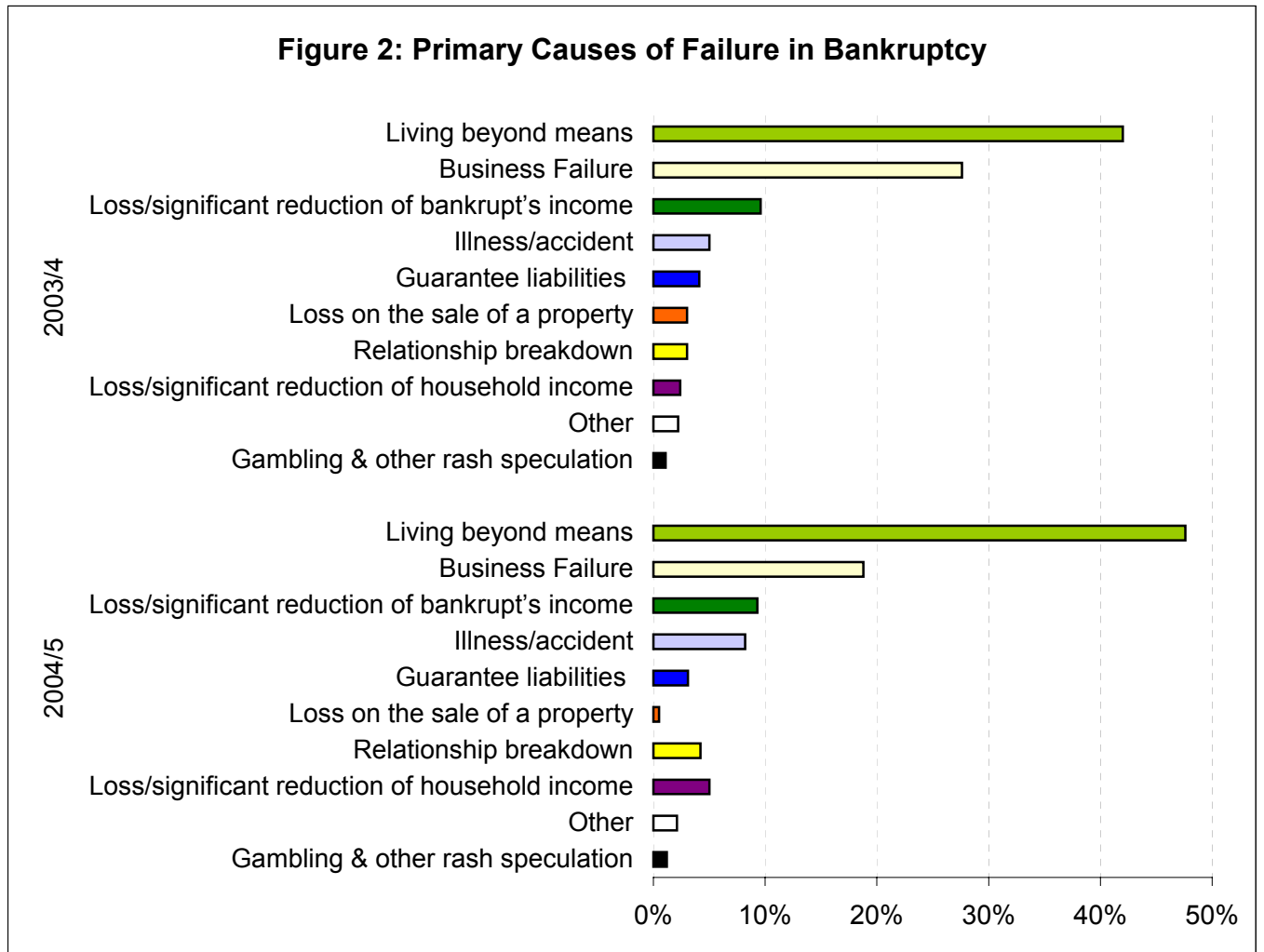
- Conversely, unplanned changes to the bankrupt's circumstances became a more common primary cause of failure over the study period. This was the primary cause of failure in 20% of cases in 2003/4, compared to 27% of cases in 2004/5 (see Figure 1).
- The most common unplanned change to a bankrupt's circumstances that was attributed as the primary cause of failure was the loss of, or significant reduction in, the bankrupt's income (see Table 2). This was primarily due to loss of employment.
- The level of cases where the primary cause of failure was attributed to the loss of, or significant reduction in, the bankrupt's income remained largely unchanged over the study period at just less than 10% (see Table 2).
- The level of cases where the primary cause of failure was attributed to other unplanned changes to a bankrupt's circumstances increased over the study period (see Table 2).

**Table 2: A breakdown of the cases where the primary cause of failure was attributed to an unplanned change to the bankrupt's circumstances**

	<b>2003/4</b>	<b>2004/5</b>
Loss/significant reduction of bankrupt's income	9.6%	9.3%
Illness/accident	5.0%	8.2%
Relationship breakdown	3.0%	4.2%
Loss/significant reduction of household income	2.4%	5.0%
<b>Total</b>	<b>20.0%</b>	<b>26.7%</b>

## 2.1 Primary Causes of Failure (bankruptcy) (continued)

- A more detailed breakdown of the primary causes of failure in bankruptcy is shown in Figure 2.



## 2.2 Business failures (bankruptcy)

- The overall level of self-employed bankrupts fell from 31% in 2003/4 to 25% in 2004/5<sup>4</sup>.
- The level of self-employed bankrupts in the sample is 33% in 2003/4 and 25% in 2004/5. Therefore, the sample is broadly representative of the population.
- As detailed above, the level of cases where the primary cause of failure was attributed to a business failure on a self-employed basis fell from 28% of cases in 2003/4 to 19% of cases in 2004/5 (see Figure 1).
- Therefore, the fall in the level of cases where the primary cause of failure was due to the failure of a business on a self-employed basis is consistent with the fall in the level of self-employed bankrupts.
- However, the level of cases where the primary cause of failure was due to the failure of a business on a self-employed basis compared to the level of self-employed bankrupts in the study period indicates that the primary cause of failure from self-employed bankrupts was mostly, but not always, due to the failure of the business.
- Moreover, the level of cases where the primary cause of failure was due to the failure of a business on a self-employed basis fell by around 30% (comparing 2003/4 with 2004/5)<sup>5</sup>, whereas the level of self-employed bankrupts fell by only about 20%<sup>6</sup>.
- Therefore, this suggests that primary cause of failure of self-employed bankrupts is increasingly attributable to factors unconnected with the bankrupt's business.

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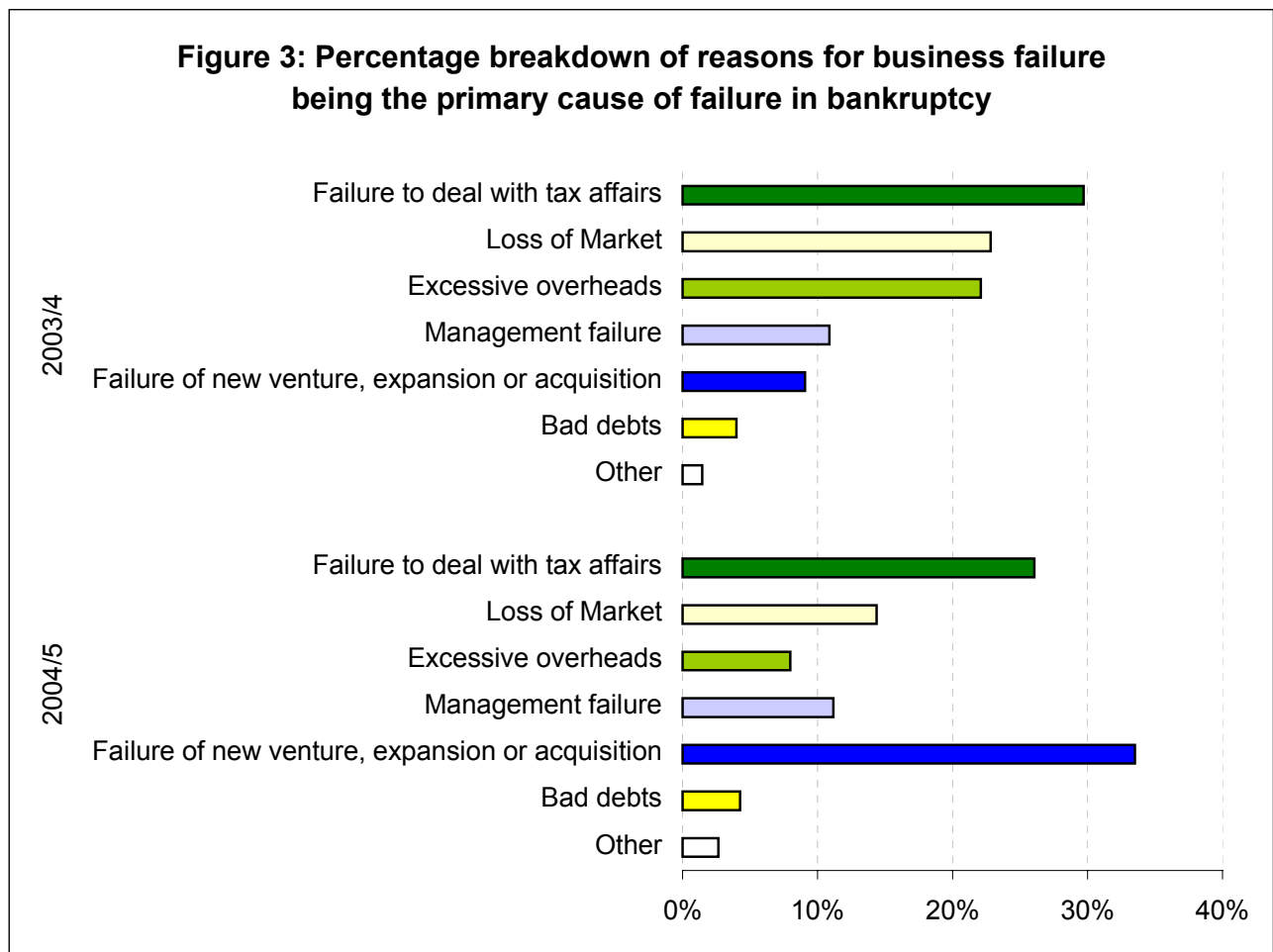
<sup>4</sup> Based on statistics published by The Insolvency Service (previously the DTI Statistics Directorate) (not seasonally adjusted)

<sup>5</sup> Based on the results of the sampling exercise

<sup>6</sup> Based on the statistics published by The Insolvency Service (previously the DTI Statistics Directorate) (not seasonally adjusted)

## 2.2 Business failures (bankruptcy) (continued)

- In 2003/4, the main reason why a business failure was the primary cause of failure in bankruptcy was due to a failure to deal with tax affairs. This accounted for 30% of cases in 2003/4 (see Figure 3).
- In 2004/5, the main reason why a business failure was the primary cause of failure in bankruptcy was due to the failure of a new venture, expansion or acquisition, i.e. a speculative business investment. This accounted for 34% of cases in 2004/5 (see Figure 3).
- The breakdown of the reasons for business failure being the primary cause of failure in bankruptcy are significantly different in 2003/4 compared to 2004/5. The level of cases where failure to deal with tax affairs, loss of market and excessive overheads were the primary cause of failure fell, whilst the level of failures of a new venture, expansion or acquisition increased (see Figure 3). Further analysis is required to ascertain whether this change is sustained over time or indicative of an on-going trend.



## 2.3 Primary causes of failure and profiling information (bankruptcy)

- The profiles of bankrupts and the primary causes of failure have been analysed to ascertain whether any significant associations exist.
- Due to the sample sizes, the primary causes of failure were categorised as:
  - A business failure
  - Living beyond a bankrupt's means
  - 'Life event', such as illness, accident or relationship breakdown
  - Reduction in income (either the bankrupt's or the household's)
  - Guarantee liabilities<sup>7</sup>
  - Other, e.g. loss on sale of property, gambling losses, etc.
- It was not possible to analyse the primary causes of failure and occupation type because of the small sample sizes of the occupations other than employed and self-employed.

### Gender

- The gender split in the sample is broadly representative of the bankruptcy population in England & Wales (see Table 3).

**Table 3: Gender split of sample compared to population figures**

		2003/4	2004/5
Percentage breakdown of gender of bankrupts in overall bankruptcy population <sup>8</sup>	Male	63%	61%
	Female	37%	39%
Percentage breakdown of gender of bankrupts in sample	Male	63%	59%
	Female	37%	41%

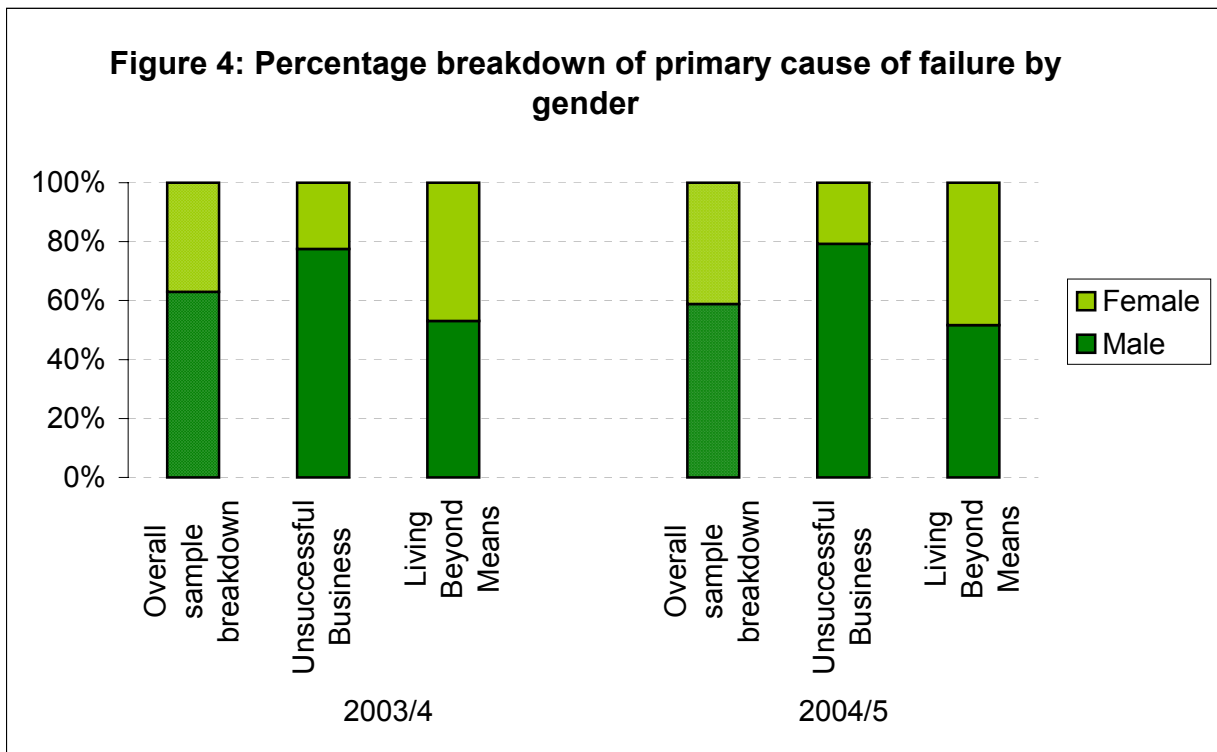
<sup>7</sup> In some cases, guarantee liabilities and 'other' were combined for the statistical analysis due to small sample sizes.

<sup>8</sup> Based on information in The Insolvency Service's report 'Characteristics of a bankrupt': <http://www.insolvency.gov.uk/insolvencyprofessionandlegislation/policychange/cob.pdf>

## 2.3 Primary causes of failure and profiling information (bankruptcy) (continued)

### Gender (continued)

- There is a significant association between the primary cause of failure and the gender of the bankrupt<sup>9</sup> for both 2003/4 and 2004/5.
- There were more men than expected with a primary cause of failure due to a business failure (see Figure 4).
- There were more women than expected with a primary cause of failure of living beyond the bankrupt's means (see Figure 4).



<sup>9</sup> The hypothesis that there is no association between gender and primary cause of failure was tested. The test showed that there was a very significant difference for both 2003/4 and 2004/5 (below 0.1% level [equivalent to  $p < 0.001$ ]).

## 2.3 Primary causes of failure and profiling information (bankruptcy) (continued)

### Age

- The age breakdown of bankrupts in the sample is broadly representative of the population (see Table 4).

**Table 4: Age breakdown of sample compared to population figures**

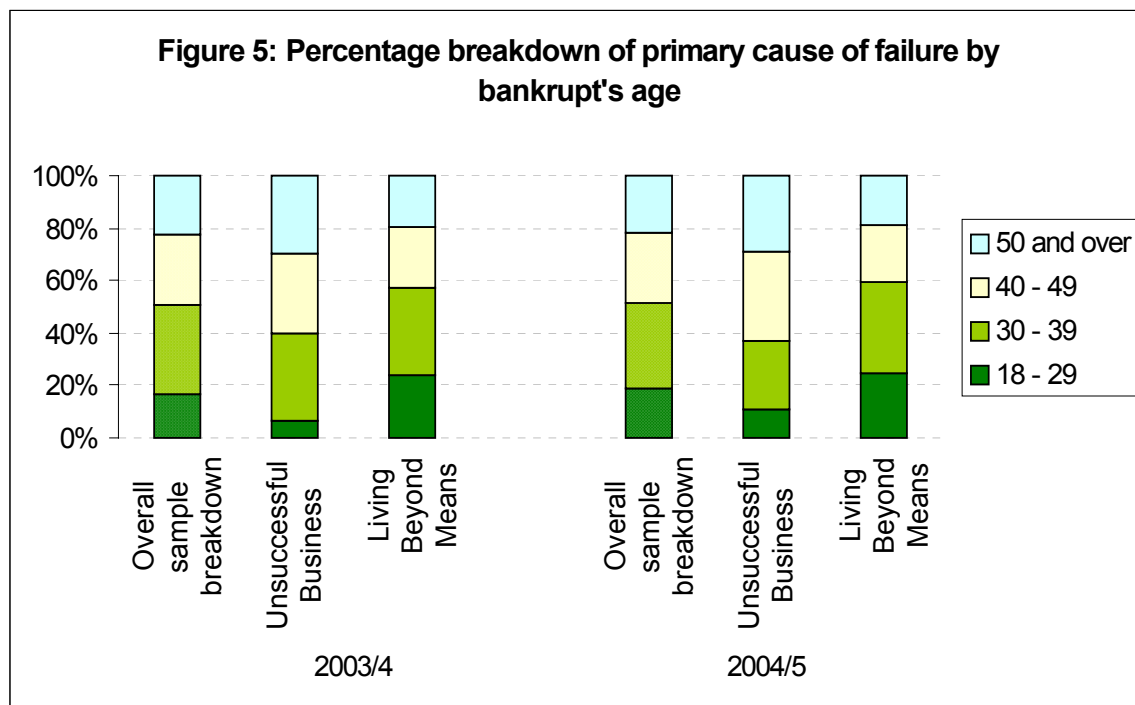
	<b>2003/4</b>	<b>2004/5</b>	
Percentage breakdown of age of bankrupts in overall bankruptcy population <sup>10</sup>	18 - 29	15%	19%
	30-39	33%	32%
	40 – 49	28%	26%
	50 and over	24%	23%
Percentage breakdown of age of bankrupts in sample	18 - 29	17%	19%
	30-39	34%	33%
	40 – 49	26%	27%
	50 and over	23%	21%

<sup>10</sup> Based on information in The Insolvency Service's report 'Characteristics of a bankrupt': <http://www.insolvency.gov.uk/insolvencyprofessionandlegislation/policychange/cob.pdf>

## 2.3 Primary causes of failure and profiling information (bankruptcy) (continued)

### Age (continued)

- There is a significant association between the primary cause of failure and the age of the bankrupt<sup>11</sup> for both 2003/4 and 2004/5.
- In 2003/4 and 2004/5, there were more bankrupts aged under 30 than expected associated with a primary cause of failure of living beyond a bankrupt's means, and conversely, fewer than expected associated with a primary cause of failure due to a business failure (see Figure 5).
- In 2003/4 and 2004/5, there were more bankrupts aged 50 and over than expected associated with a primary cause of failure due to a business failure (see Figure 5).
- In 2004/5 only, there were significantly fewer bankrupts aged 40 to 49 than expected with a primary cause of failure of living beyond a bankrupt's means (see Figure 5).



<sup>11</sup> The ages were banded as follows: '18-29', '30-39', '40-49' and '50 and over'. Also, the primary cause of failure categories 'Guarantee liabilities' and 'Other' were combined. The hypothesis that there is no association between age and primary cause of failure was tested. The test showed that there was a very significant difference for both 2003/4 and 2004/5 (below 0.1% level [equivalent to  $p < 0.001$ ]).

## 2.3 Primary causes of failure and profiling information (bankruptcy) (continued)

### Petition type

- The petition breakdown in the sample is broadly representative of the bankruptcy population in England & Wales (see Table 5).

**Table 5: Petition split of sample compared to population figures**

		2003/4	2004/5
Percentage breakdown of petition type of bankrupts in overall bankruptcy population <sup>12</sup>	Debtor's petition	72%	79%
	Creditor's petition	28%	21%
Percentage breakdown of petition type of bankrupts in sample	Debtor's petition	74%	82%
	Creditor's petition	26%	18%

- There is a significant association between the primary cause of failure and the petition type of the bankrupt<sup>13</sup>. Similar variations were found in 2003/4 and 2004/5.
- There were more bankruptcies based on a creditor's petition than expected associated with a primary cause of failure due to a business failure (see Figure 6).
- There were more bankruptcies based on a debtor's petition than expected associated with a primary cause of failure of living beyond the bankrupt's means (see Figure 6).

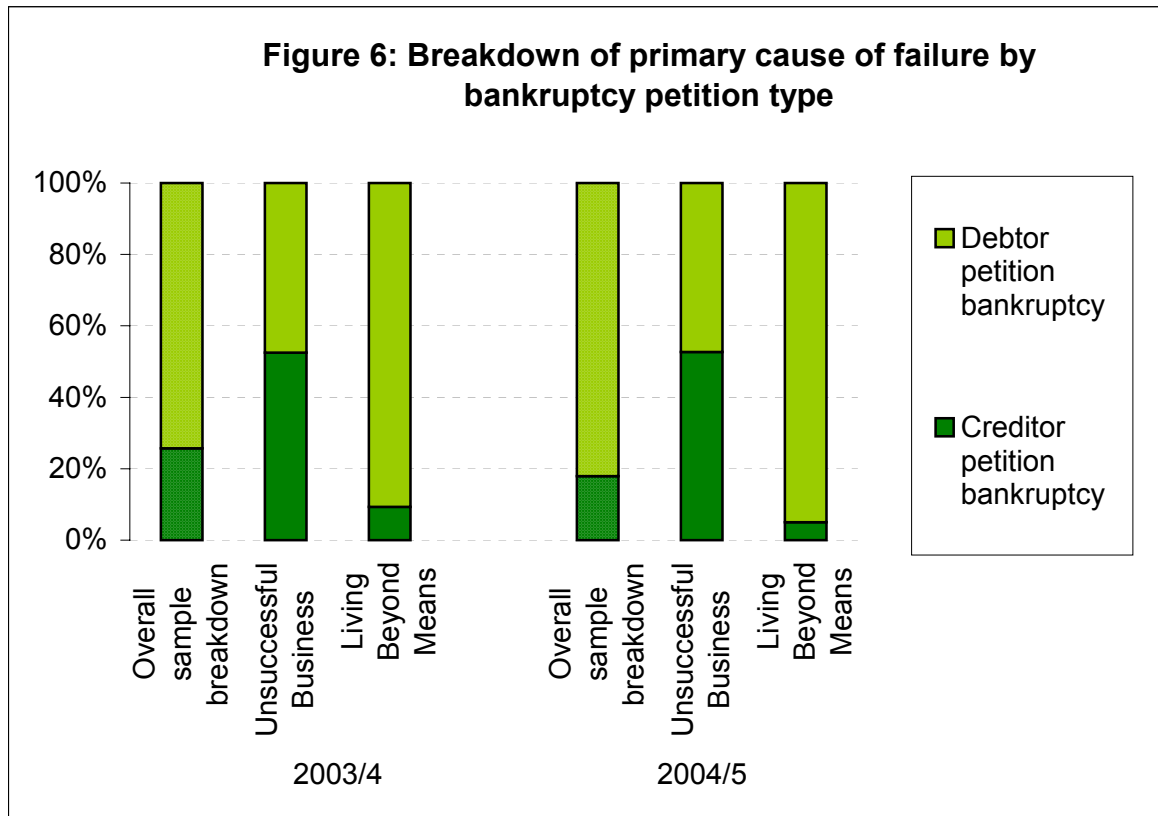
<sup>12</sup> Based on information in The Insolvency Service's report 'A Study of Creditors petitioning for bankruptcy':

<http://www.insolvency.gov.uk/insolvencyprofessionandlegislation/policychange/BankruptcyPetitioningCreditors1.pdf>

<sup>13</sup> The hypothesis that there is no association between petition type and primary cause of failure was tested. The test showed that there was a very significant difference for both 2003/4 and 2004/5 (below 0.1% level [equivalent to  $p < 0.001$ ]).

## 2.3 Primary causes of failure and profiling information (bankruptcy) (continued)

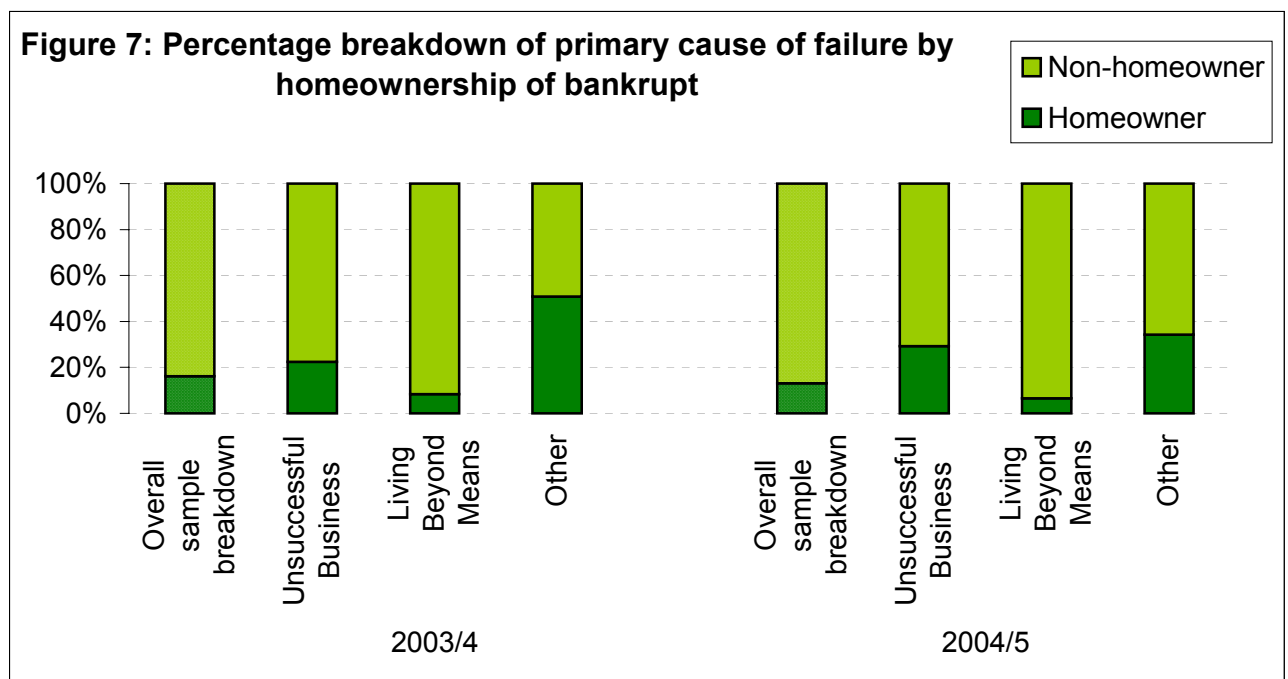
Petition type (continued)



## 2.3 Primary causes of failure and profiling information (bankruptcy) (continued)

### Homeowners

- The level of bankrupts who owned homes in the sample is 16% and 13% for 2003/4 and 2004/5 respectively. This is higher than estimates for the population figure, which is less than 10% based on previous sampling exercises<sup>14</sup>.
- There is a significant relationship between the primary cause of failure and whether the bankrupt is a homeowner<sup>15</sup> for both 2003/4 and 2004/5.
- There were more bankrupts owning homes than expected associated with a primary cause of failure due to a business failure (see Figure 7).
- There were fewer bankrupts owning homes than expected associated with a primary cause of failure of to living beyond the bankrupt's means (see Figure 7).
- There were more bankrupts owning homes than expected associated with a primary cause of failure categorised above as 'other' (see Figure 7).



<sup>14</sup> Based on information in The Insolvency Service's second interim evaluation report on the bankrupt's home provisions of the Enterprise Act 2002:

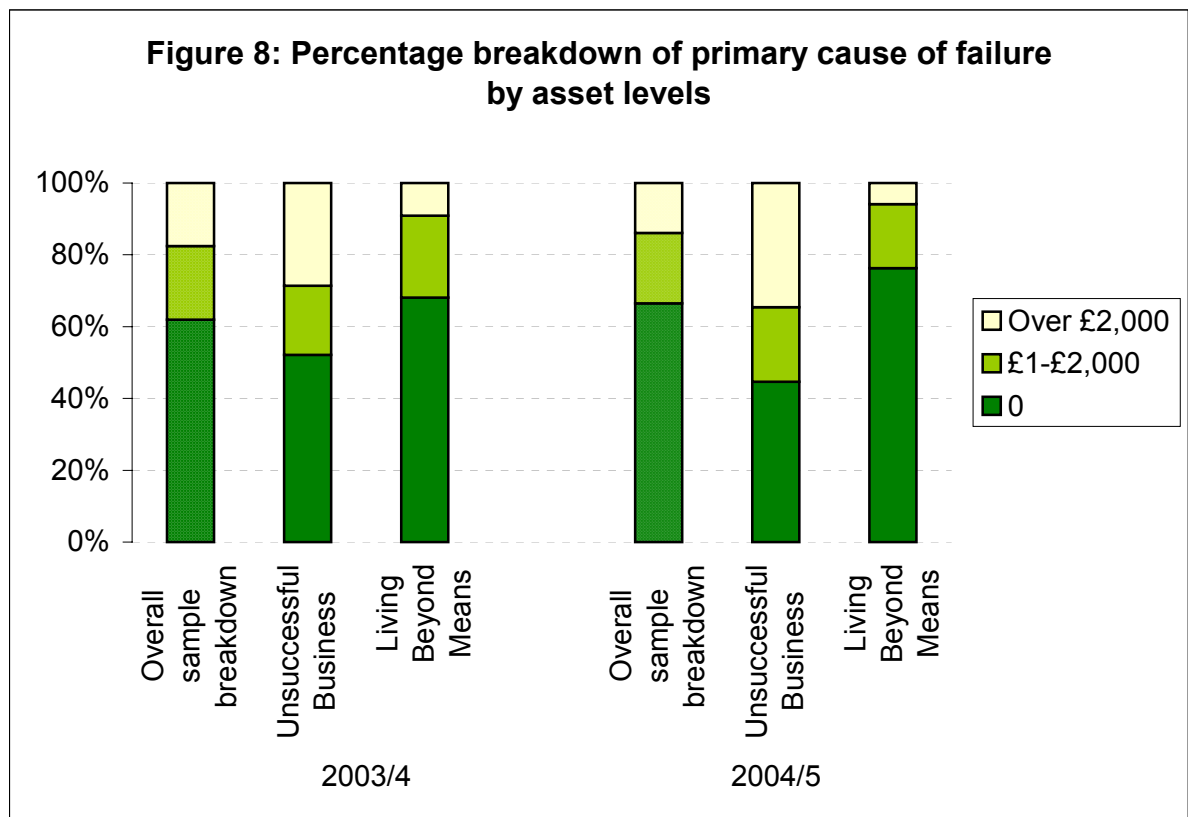
<http://www.insolvency.gov.uk/insolvencyprofessionandlegislation/legislation/evaluation/Bankruptshome/bankruptshome2.pdf>

<sup>15</sup> The hypothesis that there is no association between homeownership and primary cause of failure was tested. The test showed that there was a very significant difference for both 2003/4 and 2004/5 (below 0.1% level [equivalent to  $p < 0.001$ ]).

## 2.3 Primary causes of failure and profiling information (bankruptcy) (continued)

### Asset levels

- There is a significant variation between the primary cause of failure and the asset level of a bankrupt<sup>16</sup> in both 2003/4 and 2004/5.
- There were more bankrupts than expected with assets of over £2,000 associated with a primary cause of failure due to a business failure (see Figure 8).
- There were fewer bankrupts than expected with assets of over £2,000 associated with a primary cause of failure of living beyond a bankrupt's means (see Figure 8).



<sup>16</sup> The asset levels were banded as follows: 'Nil', '£1 – £2,000' and 'Over £2,000'. The hypothesis that there is no association between asset levels and primary cause of failure was tested. The test showed that there was a very significant difference for both 2003/4 and 2004/5 (below 0.1% level [equivalent to  $p < 0.001$ ]).

## 2.3 Primary causes of failure and profiling information (bankruptcy) (continued)

### Liability levels

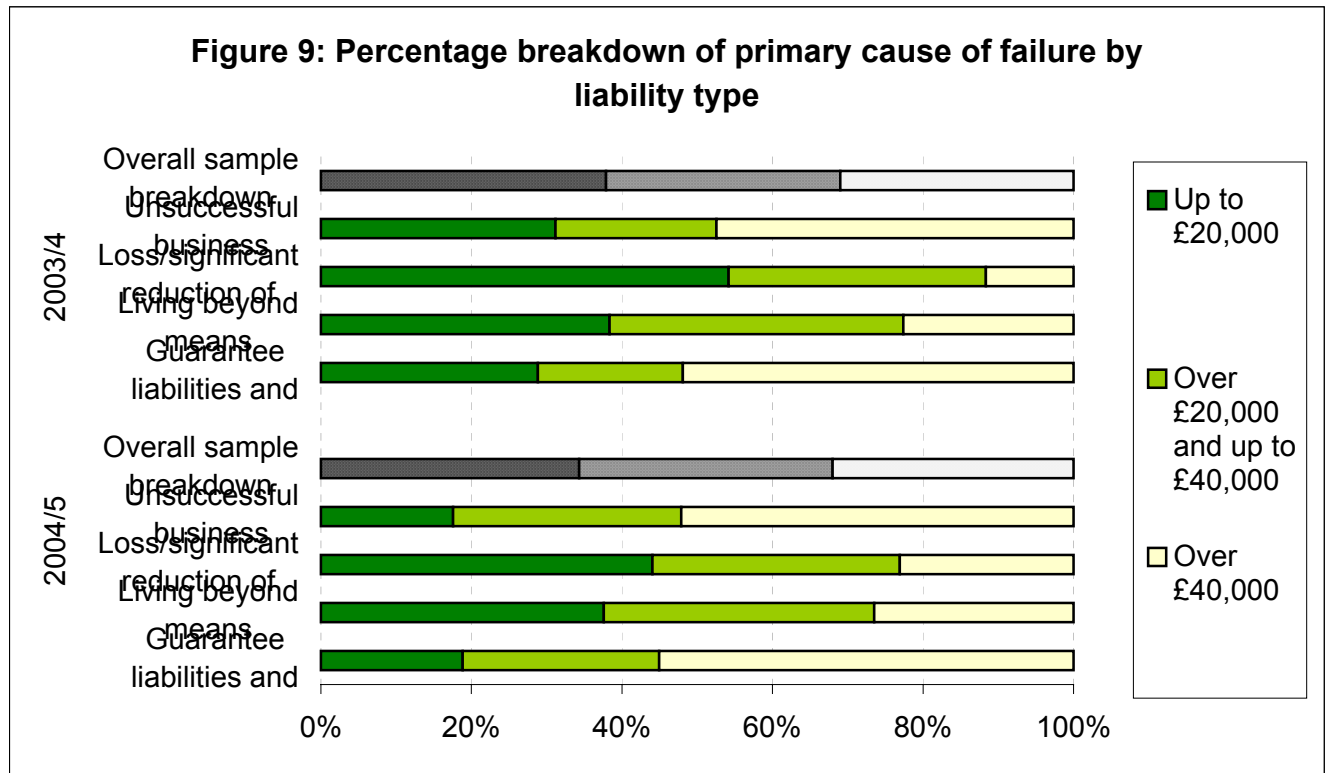
- There is a significant association between the primary cause of failure and the liability level of a bankrupt<sup>17</sup> for both 2003/4 and 2004/5.
- In 2003/4, there were more bankrupts than expected with a primary cause of failure due to a business failure associated with liabilities of £40,000 and over. In 2004/5, bankruptcies due to a business failure became more common than expected as the liability levels increased. This suggests that a primary cause of failure due to a business failure is associated with higher amounts of liability (see Figure 9).
- In 2003/4, bankruptcies due to a loss of income became less common than expected as the liability levels increased. In 2003/4 and 2004/5, there were more bankrupts than expected with a primary cause of failure due to loss of income associated with liabilities of under £20,000. This suggests that a primary cause of failure due to loss of income is associated with lower levels of liability (see Figure 9).
- In 2003/4, there were more bankrupts than expected with a primary cause of failure of living beyond a bankrupt's means associated with liabilities of over £20,000 up to £40,000. This variation is not seen in 2004/5, where the causes of failure for bankruptcies with such liabilities are close to that expected (see Figure 9).
- In 2003/4 and 2004/5, as well as there being more bankrupts than expected with a primary cause of failure due to a business failure, there are more bankrupts than expected with a primary causes of failure due to guarantee liabilities and other factors with liabilities of £40,000 and over.

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<sup>17</sup>The liability levels were banded as follows: 'Up to £20,000', 'Over £20,000 up to £40,000' and 'Over £40,000'. Also, the primary cause of failure categories 'Guarantee liabilities' and 'Other' were combined. The hypothesis that there is no association between liability levels and primary cause of failure was tested. The test showed that there was a very significant difference for both 2003/4 and 2004/5 (below 0.1% level [equivalent to  $p < 0.001$ ]).

## 2.3 Primary causes of failure and profiling information (bankruptcy) (continued)

### Liability levels (continued)



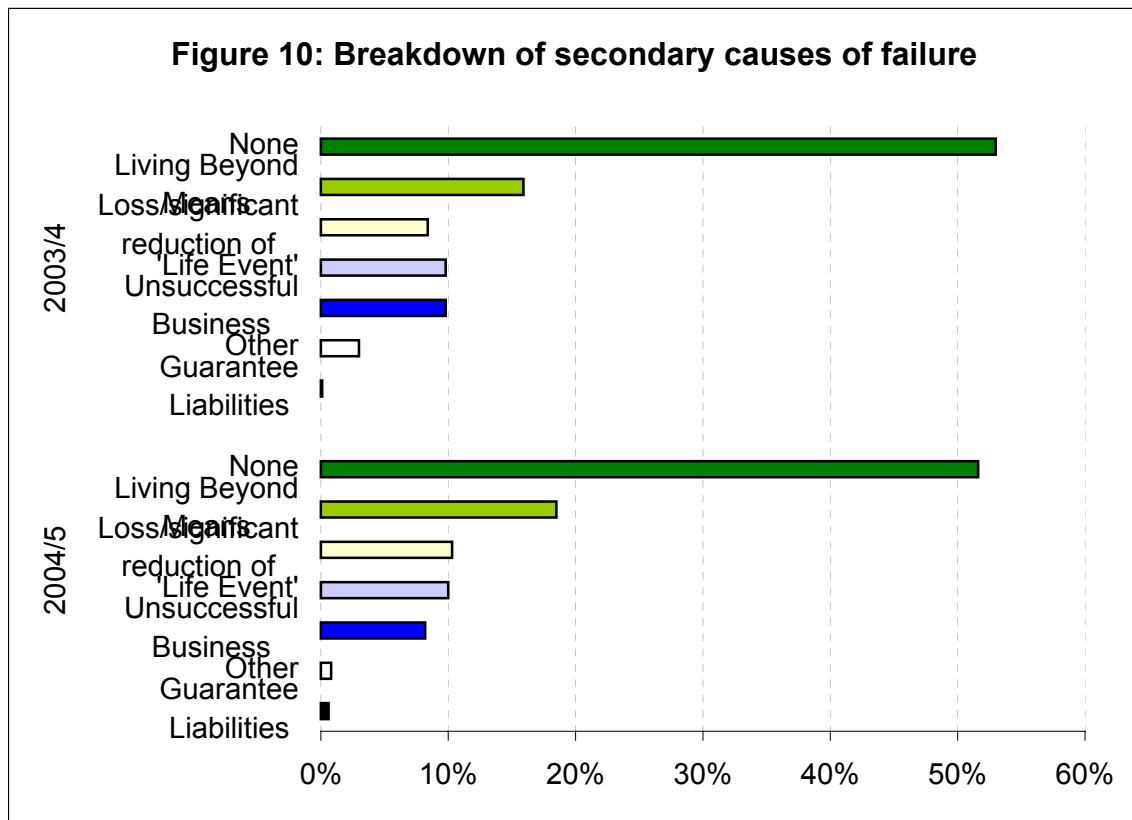
### Deficiency levels

- There is a significant association between the primary cause of failure and the deficiency level of a bankrupt<sup>18</sup> for both 2003/4 and 2004/5, and the specific variations were similar to those seen for liability levels.

<sup>18</sup>The deficiency levels were banded as follows: 'Up to £20,000', 'Over £20,000 up to £40,000' and 'Over £40,000', and surplus cases, i.e. where the bankrupt's assets exceeded his/her liabilities, were removed. Also, the primary cause of failure categories 'Guarantee liabilities' and 'Other' were combined. The hypothesis that there is no association between deficiency levels and primary cause of failure was tested. The test showed that there was a very significant difference for both 2003/4 and 2004/5 (below 0.1% level [equivalent to  $p < 0.001$ ]).

## 2.4 Secondary and tertiary causes of failure (bankruptcy)

- A secondary cause of failure was identified in just under 50% of cases (see Figure 10).
- Where a secondary cause of failure was identified, the main causes are the same as identified for the primary cause of failure – living beyond a bankrupt's means, a business failure and unplanned changes to the bankrupt's circumstances, i.e. 'life events' (illness, an accident or a relationship breakdown) and the loss or reduction of income (either of the bankrupt or his/her household) (see Figure 10).



## 2.4 Secondary and tertiary causes of failure (bankruptcy) (continued)

- A tertiary cause of failure was only identified in around 10% of cases. Once again, where a tertiary cause of failure was identified, the main causes are the same as identified for the primary cause of failure – living beyond a bankrupt’s means, a business failure and unplanned changes to the bankrupt’s circumstances, i.e. ‘life events’ (illness, an accident or a relationship breakdown) and the loss or reduction of income (either of the bankrupt or his/her household).
- Looking at all causes of failure identified, the level of cases where living beyond a bankrupt’s means was an identified cause of failure has increased over the study period from 63% to 70% (see Table 6).
- Similarly, looking at all causes of failure identified, the level of cases where a business failure was an identified cause of failure has fallen over the study period from 31% to 21% (see Table 6).
- The level of self-employed bankrupts in the sample 2003/4 and 2004/5 was 33% and 25% respectively. Therefore, this indicates that in the vast majority of cases, the failure of a business was a contributory factor in the bankruptcy of self-employed bankrupts.
- Finally, looking at all causes of failure identified, the level of cases where an unplanned change in the bankrupt’s circumstances was an identified cause of failure increased over the study period from 34% to 41% (see Table 6).

**Table 6: Summary breakdown of the causes of failure in bankruptcy<sup>19</sup>**

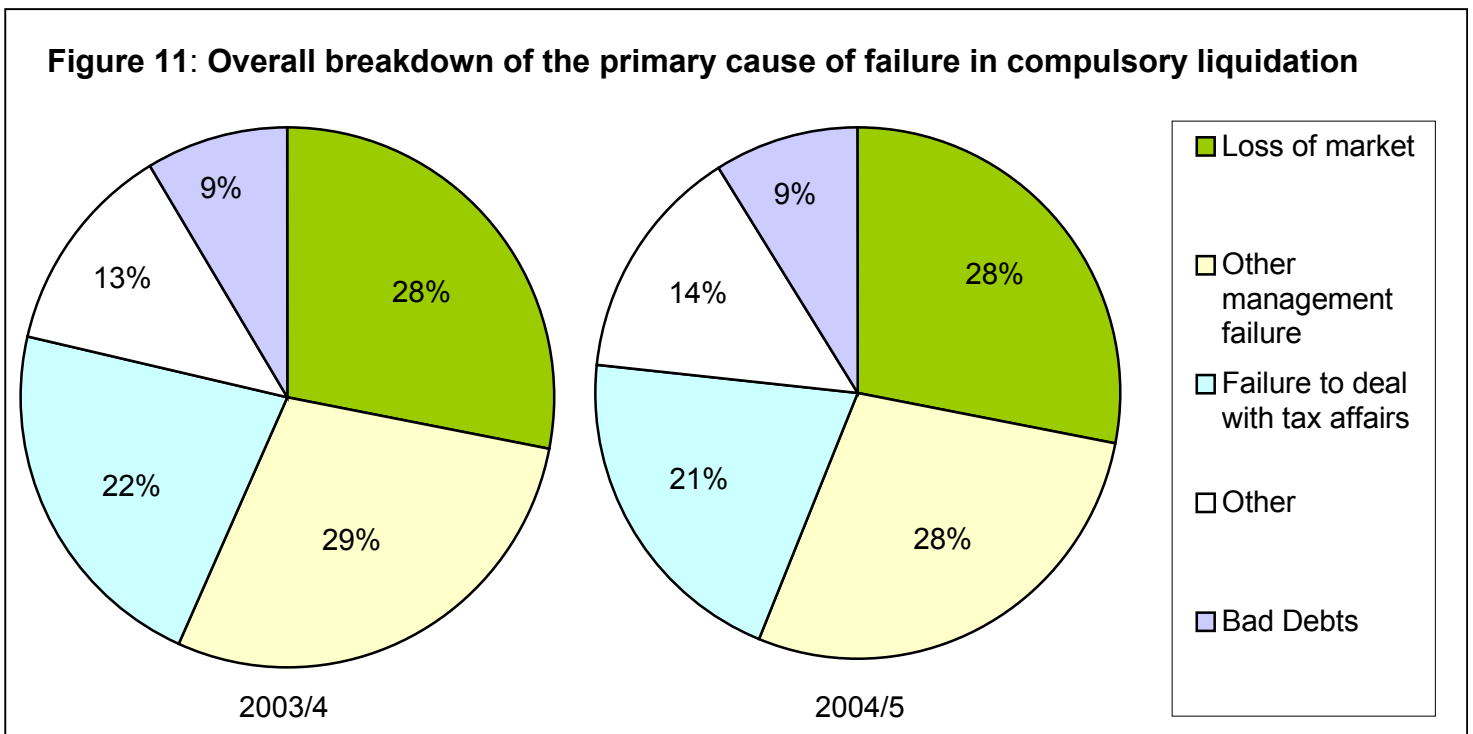
	2003/4				2004/5			
	Primary	Secondary	Tertiary	Total	Primary	Secondary	Tertiary	Total
<b>Living beyond means</b>	42%	16%	5%	<b>63%</b>	48%	19%	3%	<b>70%</b>
<b>Business failure</b>	28%	2%	1%	<b>31%</b>	19%	2%	0%	<b>21%</b>
<b>Unplanned changes to the bankrupt's circumstances</b>	20%	13%	1%	<b>34%</b>	27%	15%	0%	<b>41%</b>

<sup>19</sup> The figures for the secondary and tertiary causes of failure for business failures have been amended to exclude cases where the business failure has already been identified as the primary cause of failure, and in the case of the tertiary cause of failure, the secondary cause of failure. Similarly, the figures for the secondary and tertiary causes of failure for unplanned changes to the bankrupt’s circumstances have been amended to exclude cases where an unplanned change to the bankrupt’s circumstances has already been identified as the primary cause of failure and, in the case of the tertiary cause of failure, the secondary cause of failure.

## Section 3: Causes of Failure in Compulsory Liquidation

### 3.1 Primary causes of failure (compulsory liquidation)

- In broad terms, the main primary causes of failure for companies in compulsory liquidation are loss of market, failure to deal with tax affairs and 'other management failures'. These were the primary causes of failure in just over three-quarters of cases in both 2003/4<sup>20</sup> and 2004/5 (see Figure 11).
- There is very little difference in the overall breakdown of the primary cause of failure for companies in compulsory liquidation in 2003/4 compared to 2004/5 (see Figure 11).



<sup>20</sup> The 2003/4 percentage figures add up to over 100% due to rounding.

### 3.1 Primary causes of failure (compulsory liquidation) (continued)

- Loss of market was the primary cause of failure in just under 30% of cases (see Figure 11). This was caused by a variety of factors, but in over 80% of such cases, loss of market was due to loss of customers, contractual/legal disputes or competition (see Table 7).

**Table 7: A breakdown of the reasons leading to a primary cause of failure due to loss of market**

	<b>2003/4</b>	<b>2004/5</b>
Loss of customers	13.1%	10.7%
Contractual/legal dispute	7.1%	8.1%
Competition	3.6%	5.1%
Increased costs	1.3%	1.4%
Supplier problems	1.5%	1.2%
Other	1.4%	1.5%
<b>Total</b>	<b>28.0%</b>	<b>28.0%</b>

- Failure to deal with tax affairs was the primary cause of failure in just over 20% of cases (see Figure 11 above).

### 3.1 Primary causes of failure (compulsory liquidation) (continued)

- 'Other management failures' were the primary cause of failure in just under 30% of cases (see Figure 11 above). The management failures were varied, but the most common were under-capitalisation, over-optimism, excessive overheads (including remuneration) and lack of, or poor, planning (see Table 8).

**Table 8: Percentage breakdown of the reasons leading to a primary cause of failure due to other management failures**

	<b>2003/4</b>	<b>2004/5</b>
Under-capitalisation	7.4%	5.9%
Over-optimism	5.1%	4.3%
Excessive overheads (including remuneration)	4.5%	7.2%
Lack of/poor planning	4.7%	5.5%
Accounting including lack of management information	2.7%	2.7%
Erosion of margin	2.3%	0.5%
Other	2.1%	2.1%
<b>Total</b>	<b>28.7%</b>	<b>28.1%</b>

### 3.2 Primary causes of failure and profiling information (compulsory liquidation)

- The profiles of companies in compulsory liquidation and the primary causes of failure have been analysed to ascertain whether any significant relationships exist.

#### Trading period

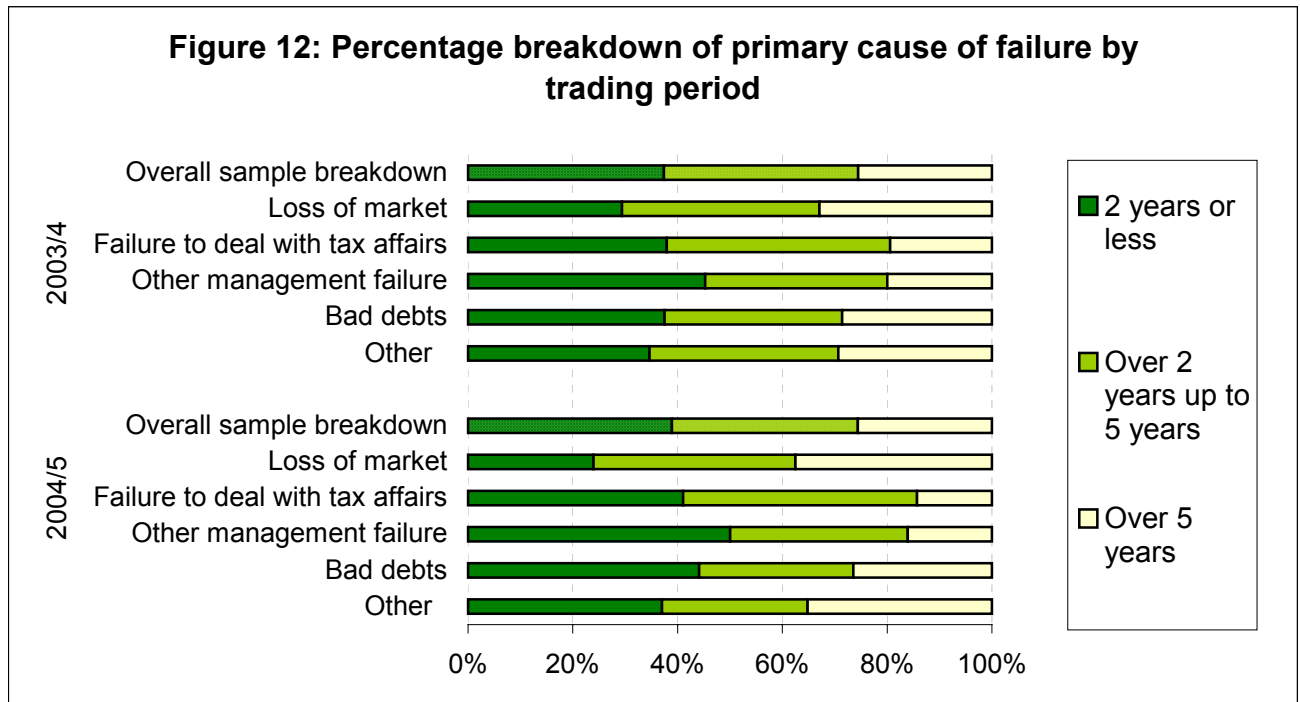
- There is a significant association between the primary cause of failure and length of trading period<sup>21</sup> in both 2003/4 and 2004/5.
- Loss of market as a primary cause of failure became more common the longer a company has traded (see Figure 12).
- For companies trading at least 5 years, failure to deal with tax affairs as a primary cause of failure was less common than expected (see Figure 12).
- 'Other management failure' was a more common primary cause of failure amongst companies that traded for less than 2 years and as the trading period increased, fewer failures were attributed to this cause (see Figure 12).
- The incidence of bad debts as a primary cause of failure did not differ significantly by trading length (see Figure 12).

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<sup>21</sup>The trading periods were banded as follows: '2 years or less', 'Over 2 years up to 5 years', and 'Over 5 years'. The hypothesis that there is no association between trading period and primary cause of failure was tested. The test showed that there was a significant difference in 2003/4 at the 5% level (equivalent to  $p=0.05$ ) and that there was a very significant difference for 2004/5 (below the 0.1% level [equivalent to  $p<0.001$ ]).

### 3.2 Primary causes of failure and profiling information (compulsory liquidation) (continued)

Trading period (continued)



## 3.2 Primary causes of failure and profiling information (compulsory liquidation) (continued)

### Business of company<sup>22</sup>

- There is a significant association between the primary cause of failure and the business sector of the company for 2003/4<sup>23</sup>. There was no significant association in 2004/5.
- In 2003/4, there were more failures than expected due to bad debts in the 'construction, transport, storage & communication' industry and conversely, fewer failures than expected due to bad debts in the 'services and other' sector.
- In 2003/4, there were more failures than expected due to 'other management failure' in the 'construction, transport, storage & communication industry' and conversely, fewer failures than expected due to other management failure in the 'manufacturing' and 'wholesale, retail and certain repair' sectors.
- As similar results are not seen in 2004/5, further analysis would be required to establish whether any conclusions could be drawn from these results.

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<sup>22</sup> The companies' business sector was classified based on the UK Standard Industrial Classification (SIC 03) Codes. Due to small numbers, sectors were combined giving the following: [Construction, Transport, Storage & Communication], [Manufacturing], [Wholesale, Retail; Certain Repair] and [Hotels, Restaurants, Other Social & Personal Services, Real Estate, Renting & Business and Other] - this last group is referred to as "services and other". Where groups have been combined, conclusions on statistical significance can only be inferred for the combined groups.

<sup>23</sup> The hypothesis that there is no association between business sector and primary cause of failure was tested. The test showed that there was a very significant difference (below the 0.1% level) for 2003/4.

## 3.2 Primary causes of failure and profiling information (compulsory liquidation) (continued)

### Number of directors

- There is a significant relationship between the primary cause of failure and the number of directors<sup>24</sup>.
- In 2003/4, there were fewer failures than expected due to a failure to deal with tax affairs associated with 3 or more directors. In 2004/5, there were more failures than expected due to a failure to deal with tax affairs with only 1 director.
- In 2003/4 and 2004/5, there were more failures than expected with 3 or more directors due to 'other' factors.
- In 2003/4, there were fewer failures than expected due to 'other management failure' associated with 1 director. In contrast in 2004/5, the incidence of 'other management failure' as a primary cause of failure did not differ by the number of directors.
- In 2003/4, the incidence of bad debts as a primary cause of failure did not differ by the number of directors.
- As different and, to some extent, contrasting variations are seen in 2003/4 and 2004/5, no definite conclusions can be drawn regarding the association between the number of directors and the primary cause of failure.

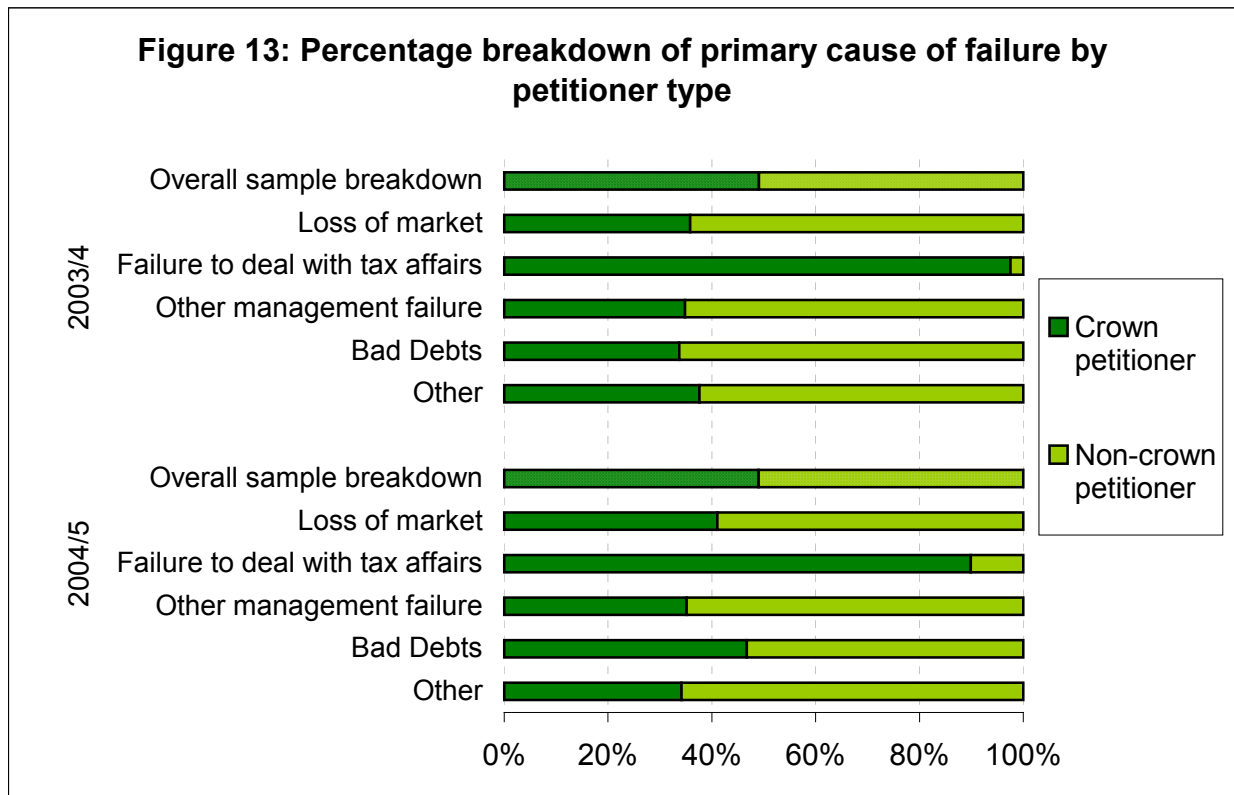
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<sup>24</sup>The number of directors was banded as follows: '1 director', '2 directors' and '3 or more directors'. The hypothesis that there is no association between the number of directors and primary cause of failure was tested. The test showed that there was a very significant difference (below the 0.1% level) for 2003/4, and a significant difference at the 2.5% level for 2004/5.

### 3.2 Primary causes of failure and profiling information (compulsory liquidation) (continued)

#### Petitioner type

- There is a significant association between the primary cause of failure and the petitioner type<sup>25</sup> for both 2003/4 and 2004/5.
- There were more failures than expected due to a failure to deal with tax affairs where the Crown was the petitioner (see Figure 13).



<sup>25</sup>Due to small samples, the petitioner type was categorised as either 'Crown' or 'Non-Crown'. The hypothesis that there is no association between the petitioner type and primary cause of failure was tested. The test showed that there was a very significant difference for both 2003/4 and 2004/5 (below the 0.1% level).

## 3.2 Primary causes of failure and profiling information (compulsory liquidation) (continued)

### Asset levels

- There is a significant association between the primary cause of failure and the asset level<sup>26</sup>.
- In 2003/4 and 2004/5, there were more failures than expected due to bad debts associated with asset levels of over £2,000. Conversely, in 2003/4 only, there were fewer failures than expected due to bad debts with no assets.
- In 2003/4, there were more failures than expected due to 'other' factors associated with no assets. In contrast, in 2004/5, the failures with no assets were distributed across the primary causes of failure close to as would be expected.
- In 2004/5 only, there were fewer failures than expected due to a failure to deal with tax affairs where asset levels were more than £2,000.
- In 2004/5 only, there were more failures than expected due to 'other' factors associated with asset levels between £1 and £2,000.
- In 2004/5 only, there are fewer failures than expected due to bad debts associated with asset levels of £1 to £2,000.
- As different and, to some extent, contrasting variations are seen in 2003/4 and 2004/5, no conclusions can be drawn regarding the association between asset levels and the primary cause of failure.

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<sup>26</sup>The asset levels were banded as follows: 'Nil', '£1 - £2,000' and 'Over £2,000'. The hypothesis that there is no association between the asset level and primary cause of failure was tested. The test showed that there was a very significant difference (below the 0.1% level) in 2003/4 and a significant difference at the 5% level for 2004/5.

## 3.2 Primary causes of failure and profiling information (compulsory liquidation) (continued)

### Liability levels

- There is a significant association between the primary cause of failure and the asset level for 2003/4 only<sup>27</sup>.
- In 2003/4, there were more failures than expected due to a failure to deal with tax affairs associated with liabilities of up to £20,000.
- In 2003/4, there were more failures than expected due to 'other' factors associated with liabilities of over £200,000.
- In 2003/4, there were fewer failures than expected due to a failure to deal with tax affairs associated with liabilities of over £200,000.
- As similar results are not seen in 2004/5, further analysis would be required to establish whether any conclusions could be drawn from these results.

### Deficiency levels

- There is a significant association between the primary cause of failure and the deficiency level for 2003/4<sup>28</sup>, but not for 2004/5.
- For 2003/4, the patterns in the relationships between the deficiency levels and the primary causes of failure are similar to those seen for liability levels.

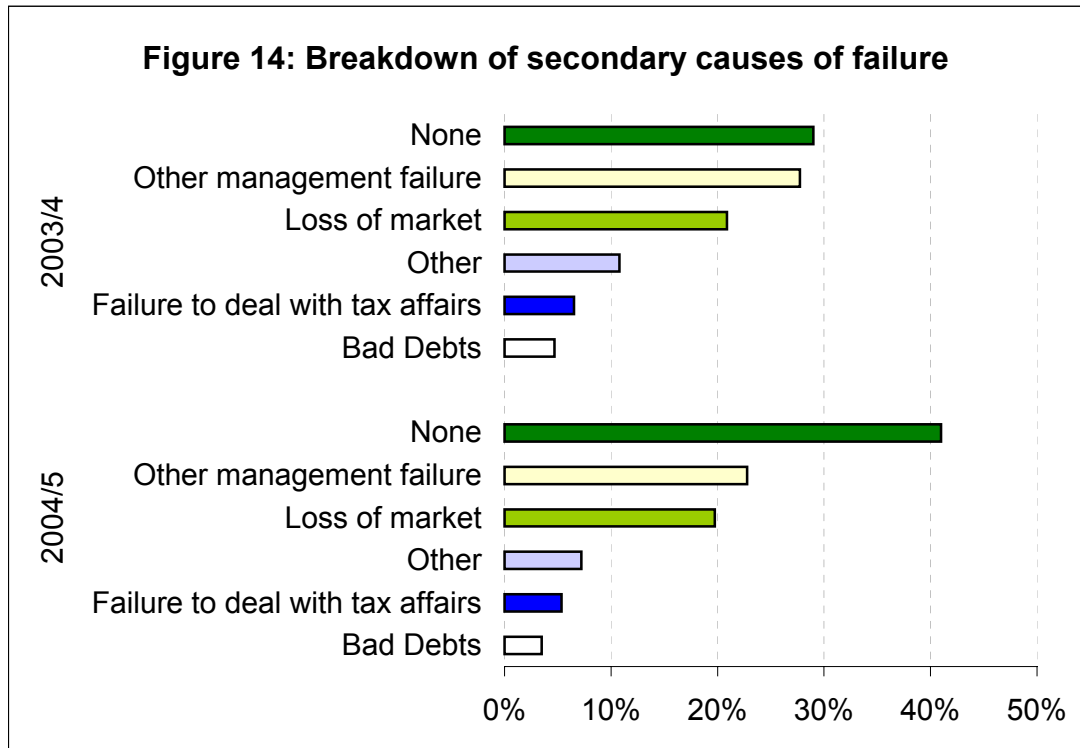
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<sup>27</sup>The liability levels were banded as follows: 'up to £20,000', 'Over £20,000 up to £50,000', 'Over £50,000 up to £100,000', 'Over £100,000 up to £200,000' and 'Over £200,000'. The hypothesis that there is no association between the liability level and primary cause of failure was tested. The test showed that there was a very significant difference (below the 0.1% level) in 2003/4.

<sup>28</sup>The deficiency levels were banded as follows: 'up to £20,000', 'Over £20,000 up to £50,000', 'Over £50,000 up to £100,000', 'Over £100,000 up to £200,000' and 'Over £200,000'. The hypothesis that there is no association between the deficiency level and primary cause of failure was tested. The test showed that there was a very significant difference (below the 0.1% level) in 2003/4.

### 3.3 Secondary and tertiary causes of failure (compulsory liquidation)

- A secondary cause of failure was identified in just over 70% of cases in 2003/4 and just under 60% of cases in 2004/5 (see Figure 14).
- Other management failure and the loss of market were the most common secondary causes of failure identified (see Figure 14).



- A tertiary cause of failure was identified in just under 30% of cases in 2003/4 and just over 20% of cases in 2004/5. Other management failure and the loss of market were the most common tertiary causes of failure identified.

### 3.3 Secondary and tertiary causes of failure (compulsory liquidation) (continued)

- Looking at all the causes of failure identified, the level of cases for the causes of failure detailed at Table 9 have all decreased over the study period. This is due to the decrease over the study period in the level of secondary and tertiary causes of failure identified in cases.

**Table 9: Summary breakdown of the causes of failure in compulsory liquidation<sup>29</sup>**

	2003/4				2004/5			
	Primary	Secondary	Tertiary	Total	Primary	Secondary	Tertiary	Total
<b>Other management failure</b>	28%	18%	5%	<b>51%</b>	28%	16%	3%	<b>47%</b>
<b>Loss of market</b>	28%	16%	5%	<b>49%</b>	28%	15%	4%	<b>47%</b>
<b>Failure to deal with tax affairs</b>	22%	7%	2%	<b>31%</b>	21%	5%	2%	<b>28%</b>
<b>Bad debts</b>	13%	5%	2%	<b>20%</b>	14%	3%	1%	<b>18%</b>

<sup>29</sup> The figures for the secondary and tertiary causes of failure for loss of market have been amended to exclude cases where loss of market has already been identified as the primary cause of failure, and in the case of the tertiary cause of failure, the secondary cause of failure. Similarly, the figures for the secondary and tertiary causes of failure for other management failure have been amended to exclude cases where another management failure has already been identified as the primary cause of failure and, in the case of the tertiary cause of failure, the secondary cause of failure.