Morning Briefings

Indicators of Insolvency

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What are the indicators or warning signs?

A range of indicators of insolvency, if identified early, can provide the opportunity to avoid business failure, or minimise further losses.

Further, the issue of solvency, or otherwise, dictates what legal responsibilities a director has to other stakeholders such as creditors and employees.

1. The statutory definition of 'solvent' is contained in Section 95A of the Corporations Act 2001 ("the Act"), which provides:

   "95A (1) A person is solvent if, and only if, the person is able to pay all the person's debts, as and when they become due and payable.

   95A (2) A person who is not solvent is insolvent."

2. There are two common meanings of 'insolvency'.

   - Cash-flow insolvency – being unable to pay debts as and when they fall due.

   - Balance sheet insolvency – assets being exceeded by liabilities.

   It is the cash-flow test that should be given greater emphasis because an inability to pay debts as and when they fall due constitutes the general law concept of insolvency. Insolvency is therefore usually determined by a commercial or cash-flow test rather than on a balance sheet approach.

3. The Court looks at the company's position in its entirety and asks whether its assets are in such a position, as to title or otherwise, that they can be realised in time to pay the company's debts as they fall due.

4. Further, it has been held that if the assets in question form an essential part of the company's business, such that it will be unable to continue to trade if they are sold, the Court will not consider them assets available for the payment of creditors.

5. A company can be temporarily cash-flow insolvent but the critical issue is whether there is an endemic lack of liquidity.

6. The important question is:

   "Can the company pay its way in carrying on its business?"

The stakeholders

- Directors
- Co-directors (not usually involved in the day to day business)
- Other management
- Employees
- Secured creditors
- Suppliers
- ATO
- Guarantors
- Shareholders
- Government

And ultimately:

- The liquidator
- ASIC

1. The earlier financial and operational problems are addressed, the earlier:
   - appropriate professional advice can be obtained.
   - corrective action can be taken.

2. The early identification of problems usually means that the recovery options and prospects are greater.

3. Usually effective turnaround is achieved only in non-crisis recovery situations.

4. Early identification and corrective action can increase the prospect of retaining contracts and the support of key stakeholders, to ensure the business does not start to spiral into a fatal crisis.

5. The insolvency of a company can have serious consequences for the directors due to insolvent trading and other legal provisions.

Insolvent Trading

- As well as general directors' duties, directors have a positive duty to ensure that a company does not trade whilst insolvent.
- A company is insolvent if it is unable to pay all its debts when they are due.
- This means that before directors incur a new debt they must consider whether they have reasonable grounds to suspect that the company is insolvent or will become insolvent as a result of incurring the debt.
- The duty to prevent insolvent trading is not a duty to prevent 'trading' per se. It is a duty not to incur debts when a company is insolvent.
- There are various penalties and consequences for directors of companies found to have been trading whilst insolvent, including civil penalties, compensation proceedings and criminal charges.

1. ASIC's sixth annual overview of corporate insolvencies was published on 29 September 2014. In this overview, data extracted from statutory reports lodged by external administrators showed that the top three nominated causes of failure were:

   - Inadequate cash-flow or high cash use (a factor in 41% of cases)
   - Poor strategic management of business (37%)
   - Trading losses (33%)

2. Causes of failure can be broadly divided into internal and external causes:

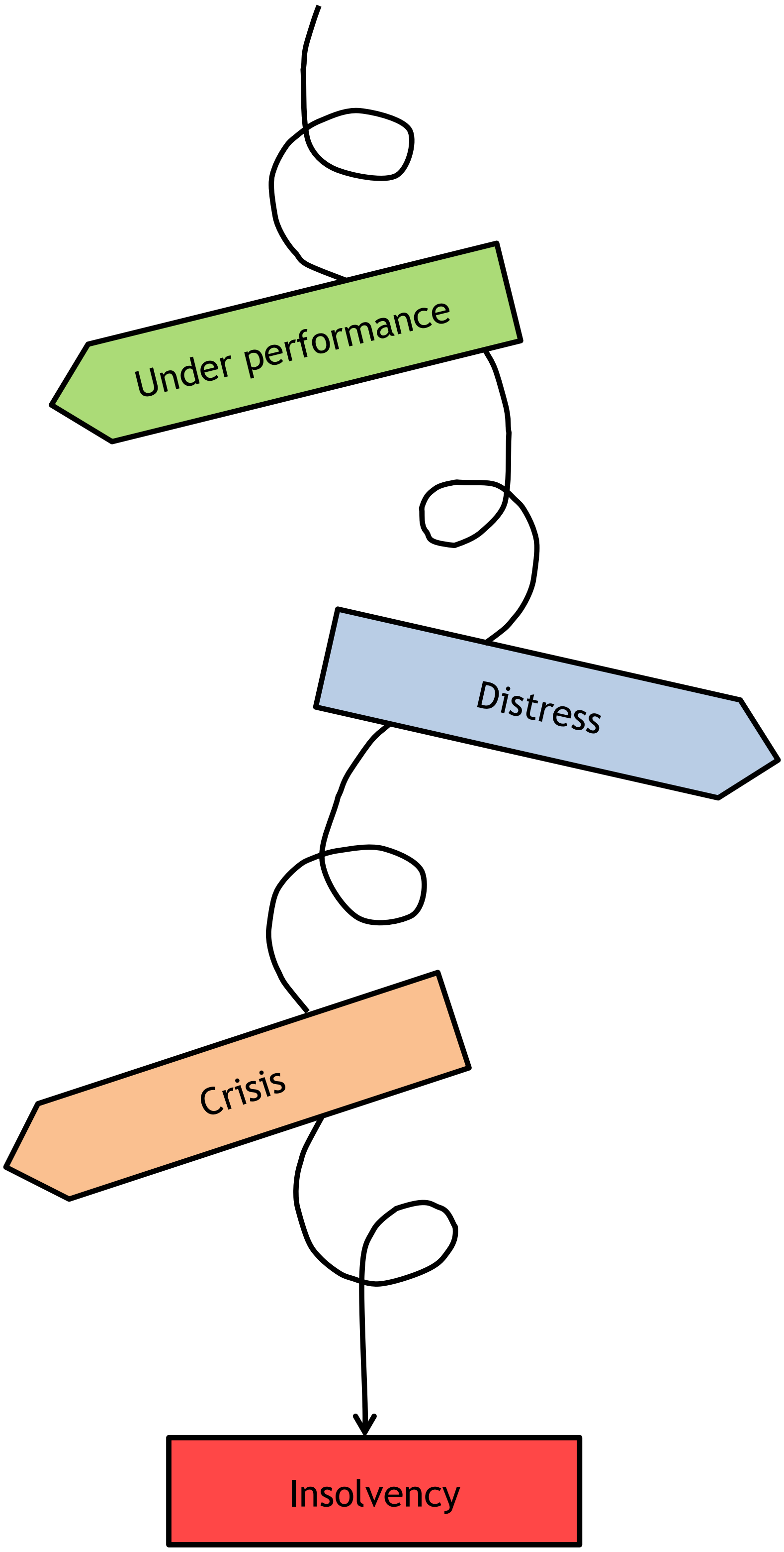
   - Internal causes of failure are generally the dominant reason for corporate failure.
   - Directors generally have greater control in taking corrective action over internal rather than external causes.

3. **Internal causes:**

   - Lack of, or failure to maintain, adequate financial records
   - Lack of financial control
   - Inappropriate financial policies
   - Inadequate leadership and management (managerial inefficiency and ineffectiveness)
   - High cost structure
   - Lack of internal operating controls
   - Reliance on limited customer base, product or service
   - Failure to keep up with legislative or technical developments
   - Uncontrolled growth (over expansion)
   - Inadequate marketing or promotion
   - Inadequate risk assessment
   - Inappropriate or inadequate credit policies and procedures
   - Inadequate staff development or training

4. **External causes:**

   - Competition
   - Market demand
   - General economic cycles
   - Structural changes
   - Socio-cultural factors
   - Government policy


Under performance
Distress
Crisis
Insolvency

The pivotal case on Indicators of Insolvency is *ASIC v Plymin (2003) 46 ACSR 126*. The Judge in this case referred to a checklist of 14 Indicators of Insolvency.

1. Continuing losses

Losses in themselves do not necessarily cause insolvency. Not every business that makes a loss, or a series of losses, is insolvent. The risk of insolvency occurs when there are continuing losses and insufficient working capital to carry the company through to a profitable period. The critical issue is the company's capacity to absorb the losses. A prolonged period of trading losses will probably reduce a company's capacity to pay its debts as they fall due.

2. Liquidity ratio below 1.0

Liquidity is a measure of the extent to which liquid assets are available to cover debts payable.

The two most commonly used liquidity ratios are the *current ratio* (current assets ÷ current liabilities) and the *quick ratio* (cash & cash equivalents + accounts receivable ÷ current liabilities).

The current ratio examines a company's ability to access funds in the short term from current or "liquid" assets to meet short-term liabilities. A ratio of less than 1.0 indicates that a company has not maintained sufficient working capital to meet day-to-day obligations to creditors and that it may be insolvent, being unable to pay its obligations to creditors as and when they fall due and payable.

The quick ratio examines the ability of the company to pay its debts by using its cash and near cash equivalents (i.e. accounts receivable and marketable securities). Again, a ratio of less than 1.0 may indicate insolvency concerns.

Whilst an indicator of insolvency, the liquidity ratio is not conclusive. The ratio is a snap-shot at a specific point in time and does not factor in the dynamics of cash-flow, in particular whether current debt is actually payable at that particular time and the true liquidity of some current assets (stock and receivables). Further, the ratio does not take into account unused finance facilities because it uses the actual funds in the bank.

3. Overdue Commonwealth & State taxes, and statutory obligations

For companies with cash-flow problems, non-payment of ATO and other statutory obligations is often seen as the easiest and quickest way to preserve essential cash in the short term. There are no credit application forms, no valuations and no bank fees.

The failure by a company to lodge tax returns on time and to maintain its statutory payment obligations, including superannuation contributions, is usually a strong indicator of insolvency. Companies will normally meet their obligations to the ATO by the due date or soon thereafter if they have the ability to do so. In most cases, those businesses that do not pay their statutory obligations do not have the capacity to pay.

4. Poor relationship with present bank including inability to borrow additional funds

Banks usually have a unique relationship with the company that gives them an advantage over other creditors. The bank is usually aware of the cash position of the company, and if the business has borrowed money from the bank, the bank may have access to the company's financial information.

A poor relationship with the company's bank can arise when the bank has had to regularly dishonour cheques, or when there has been non-repayment of monies due to the bank or rejection of finance applications by the bank. Often the poor relationship is a consequence of the bank's lack of confidence in the company's financial position, capability, viability and management of the business.

A strained relationship with a bank does not prove that the customer is insolvent, just as a good relationship is not proof of solvency. Sometimes the bank is the last to know of a customer's insolvency because while the company has failed to pay other creditors, it has operated within agreed limits with the bank.

However, a bank is often the company's main source of new funding and if that avenue is closed, a company will have limited options.

5. No access to alternative finance

The inability to pay debts is linked directly to the inability to obtain ready cash and to debts being "due and payable". Two financing options are:

(i) The replacement of short-term debt with long-term debt, usually borrowed according to more relaxed lending criteria, although on less favourable terms (i.e. higher interest rates).

(ii) The borrowing of funds to pay debts due i.e. creating new debt to pay old debt.

Obviously any financier would make a financial assessment of the company before lending new funds or converting funds to alternative debt. The inability of a company to source necessary funding for cash-flow may indicate problems for the financial sustainability of the company.

6. Inability to raise further equity capital

Equity capital is a third form of financing that provides cash for the company. Potential equity investors knowing that an eventual return may be delayed or uncertain are likely to be diligent in reviewing the finances and prospects of a company in an effort to be satisfied that the return is commensurate with the risk.

While it is of concern if current shareholders are not willing to increase their stake in the company to ensure its future viability, there may be a number of reasons for the lack of investor confidence, including a lack of desired profitability, rather than solvency concerns.

6. Inability to raise further equity capital (cont.)

A company's inability sufficiently to convert short-term debt to long-term debt, or borrow money to overcome a cash crisis, or replace debt with equity to cure a lack of funds is a strong indicator that the company has a cash-flow problem, and is possibly insolvent. It suggests that the cash-flow problem is not simply a short term cash-flow problem.

7. Supplier placing the debtor on 'cash on delivery' (COD) terms, or otherwise demanding special payments before resuming supply

These are both clear indicators of a deterioration of a company's trading relationship with suppliers and an inability to meet its on-going liabilities.

Creditors are the first to know that their invoices are not being paid on time. Efficient credit managers will have systems to identify overdue accounts and effect prompt collection action. Initial collection action will usually involve collection letters or calls. Being placed on COD terms usually indicates that, at least temporarily, the supplier has no faith in the customer's ability to meet future credit commitments.

Similarly, requests for special payments will usually come as a result of a supplier's fear of non-payment and their desire to ensure repayment.

8. Creditors unpaid outside trading terms

If a significant portion of a company's trade liabilities are outside normal trading terms (usually 30 days, depending on the industry), it is a sign of an inability to satisfy its debts as they fall due.

While a company may just be an habitual late payer of accounts, even when sufficient funds exist, the existence of a range of creditors with accounts outside their agreed terms is a strong indicator of insolvency.

9. Issuing of post-dated cheques

Solvent companies very rarely issue post-dated cheques and they are usually an admission by the company that there are insufficient funds to pay now. It is often a sign of optimism by both the debtor and the creditor that the money will be readily available when the cheque is presented; however, the issuing of a post-dated cheque for current debt is one of the classic signs of insolvency. It demonstrates that the company has extended past its current cash resources in attempting to satisfy its current debts.

A company which has a long history of issuing post-dated cheques is almost certainly insolvent and relies on future monies to pay current commitments. A company which infrequently resorts to post-dated cheques is more likely to be suffering a short-term cash-flow problem rather than insolvency.

10. Dishonouring cheques

Generally a cheque is dishonoured by the bank because there are insufficient funds available to cover the payment. On occasions, this can be inadvertent through no fault of the company. The dishonouring of one cheque, or even a few cheques, is not necessarily clear evidence of insolvency. However, repeated dishonouring of cheques must equate to an inability to meet all debts when they fall due, and it is likely that the conclusion of insolvency is inevitable.

Many post-dated cheques end up being dishonoured on presentation. The issuing of post-dated cheques is often a sign of misplaced optimism and a strong indicator of insolvency. The dishonouring of a post-dated cheque signals that the company's cash-flow is at best inadequate and it is a clear message that the company's problems are more than simply a short-term cash-flow problem.

11. Special arrangements with selected creditors

As with special payments to creditors, special arrangements with creditors usually result from a supplier's fear of non-payment and their desire to ensure payment.

Special arrangements with only a few selected creditors may suggest that the business is struggling with its cash-flow and seeking to maintain vital supply from key suppliers, while neglecting non-vital suppliers. It is not uncommon in insolvency scenarios to see a business attempting to source substitute suppliers for key supplies when it can no longer obtain further credit from, and is unable to pay, existing suppliers.

12. Payments to creditors of rounded sums, which are not reconcilable to specific invoices.

Lump sum (round) payments are evidence that a company does not have sufficient cash to meet its obligations as and when they fall due and instead is resorting to making payments based on the cash available at the time, rather than paying specific invoices within trading terms. The lump sum payments are a sign that the company hopes to resolve the situation in the near future and that the creditor will be satisfied with a series of small payments.

Entering into such a payment arrangement, with or without the creditor's agreement, is an admission that the company cannot meet the full debt when due, otherwise the revised arrangement would not be necessary.

If the revised arrangement is clearly agreed with the creditor, it is possible that the company has addressed its insolvency by negotiating extended payment terms, as the full amount is no longer due and payable.

However, often the lump sum payments are being made without a revised arrangement having been made with the creditor. The payments are usually being made because the company cannot pay the debt in full and the company is no longer confident of negotiating extended arrangements with creditors. The company hopes to obtain extended credit terms unilaterally by making part-payment. The company is in all likelihood insolvent, shuffling a small amount of cash to pay a large amount of outstanding debts.

13. Solicitors' letters, summonses, judgements or warrants issued against the company

The issuing of demands by solicitors is usually an indication that a creditor has exhausted all avenues to recover its outstanding debt, and has had to resort to obtaining the assistance of an external third party to get collection of the debt.

A single letter of demand from a creditor or their solicitor is not proof of insolvency, as there may be a dispute between the parties. However, a series of demands from a number of creditors is a strong indicator of insolvency. It would be unusual for a business to have several disputes with their suppliers at the same time. If the creditor progresses beyond the demand stage and obtains a judgement that remains unpaid, there is a high likelihood of insolvency. Creditors resorting to legal recoveries is a clear sign that a company is not able to pay its debts in a timely manner.

14. Inability to produce timely and accurate financial information to display the company's trading performance and financial position, and make reliable forecasts.

This indicator has links to Section 286 and Section 588FE of the Act, which deal with the deeming of insolvency when a company has failed to keep proper books and records. A company that has failed to maintain its obligation pursuant to Section 286 of the Act to keep proper financial records, is presumed to be insolvent according to Section 588FE of the Act.

The mere fact that a company does not keep financial records does not necessarily mean that it is insolvent. On occasion, a solvent business is unable to prepare accounts, at least in the short-term, because of some administrative disorganisation e.g. an incompetent accountant.

However, historically insolvent companies rarely have reliable, up to date and readily available financial information. Further, they often demonstrate a real reluctance to prepare reliable and timely accounts. Reluctance to update financial accounts is usually attributable to avoidance by directors of the realisation that the company is in fact insolvent.

Without accurate and timely financial information, the directors will not know the extent of the deficiency (this is very common) and they will not be able to convince banks or other creditors that there is a solution to their problems.

Experience of the Courts and insolvency practitioners is that insolvency generally goes hand in hand with financial records in disarray.

Early warning signs

- Cash shortages
- Liquidity strains
- Overdue accounts receivable
- 'Stretched' payment of accounts payable

Mid warning signs

- Increase in stock (in particular, old and obsolete stock)
- Increase in bank advances
- Breaches in bank covenants
- Decreases in gross profit margins
- Erosion of customer confidence
- Impotence & inactivity of management
- Non-attendance to statutory responsibilities (taxes and superannuation)
- Poor record keeping
- Poor budgets, cash-flow forecasts and business plans
- Bounced cheques, dishonour fees and delayed electronic authorisations
- Bank overdraft at limit
- Special arrangements with creditors
- Legal action
- Deteriorating physical aspects of the business
- Poor staff demeanour

Late term warning signs

- Significant ageing of accounts payable (greater than 90 days)
- Continuing decrease in stock turnover
- Staff cutbacks and redundancies
- Supply from key suppliers cancelled or cut-off
- Loss of key personnel
- Deteriorating relationship with key customers/clients and other stakeholders
- Absence and unavailability of management (non-communication)
- Notice of event of default in key business contract

Indicators of Insolvency
Industry-specific warning signs

Construction

- Underquoting
- Cost over-runs
- Unapproved variations
- Unrecoverable retentions
- Diversification beyond experience
- Profits locked up in disputes
- Site closures

Manufacturing

- Unfavourable credit terms
- Decline in number and value of orders
- High scrap rates
- Union disputes

Retail

- Declining sales
- Fixed or increasing cost base
- Surplus and obsolete inventory
- Negative social media
- Global and online competition
- Continual wage increases

A company exhibiting a few of the indicators of insolvency may not necessarily be terminally insolvent but may be simply experiencing short-term cash-flow problems.

A shortage of funds can be described as a short-term cash-flow problem only if it is certain that problem will be overcome in the short-term.

If several (or numerous) indicators are identified over a prolonged period of time, it then may be the case that the company is insolvent.

Clearly, the directors and management need to carefully consider and evaluate the position of the company where several indicators of insolvency are noted.

If the directors of a company suspect that the company is in financial difficulty, they should seek proper professional advice as early as possible, as this increases the likelihood that the company will survive.

Directors cannot afford to have a *'head in the sand'* attitude, hoping that things will improve. They rarely do.