O'BRIEN PALMER

INSOLVENCY & BUSINESS ADVISORY

"RECOGNISING THE INSOLVENCY WARNING SIGNS IN YOUR BUSINESS"

LIAM BAILEY
MANAGING PARTNER

OBP BUSINESS UPDATES
OCTOBER 2023

1 INTRODUCTION

This is a resource for business owners, directors, accountants and financial advisors, and sets out some of the warning signs of insolvency that can be observed by ordinary business people on a day to day basis, as well as outlining the serious consequences for business owners who fail to recognise and act on those warning signs.

The current economic climate is causing many businesses to experience cash flow pressures, whether it be from reduced revenue or debtors failing to pay within trade terms. In these times, monitoring cash flow is of paramount importance to the survival of a business. Failure to ensure adequate working capital may ultimately result in liquidation or bankruptcy.

The warning signs of insolvency, as set out in this newsletter, need to be recognised and addressed in a timely manner. By obtaining professional and competent advice from solicitors, accountants and advisors, more positive outcomes can be generated for all stakeholders than might otherwise be available should business owners and directors remain in denial of the issues facing their businesses. It is important that early action is taken in order to prevent the negative consequences of business failure impacting on directors and their families.

2 DEFINING INSOLVENCY

Section 95A of the Corporations Act 2001 states that;

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

AND

(ii) "A person who is not solvent, is insolvent."

The same definition is set out in subsection 5(2) and 5(3) of the Bankruptcy Act 1966.

The solvency test imposed by law is a cash flow test, rather than a balance sheet test. Assessing solvency is not as simple as the above definition implies. At the simplest level, solvency is assessed by comparing the available current assets to the extent of liabilities that are due and payable. This is the first step when considering a 'cash-flow test' of solvency. Only those assets that can be readily converted into cash, such as debtors or stock, are taken into account as an available resource. Similarly, only amounts that are currently due and payable are to be considered.

However, it is necessary to look at the entirety of a company's circumstances, rather than focusing on any one factor. Many other factors need to be taken into account, such as the ability of the business to realise assets, utilise credit resources or refinance existing debt.

3 WARNING SIGNS OF INSOLVENCY

Being aware of the warning signs of insolvency allows directors and business owners to address those issues which may be impacting on the viability of their businesses, and to seek appropriate advice in a timely manner.

In our experience, the earlier that action is taken, the better the outcome. As the solvency of a business deteriorates, three distinct phases of warning signs can be readily identified;

(i) Early Warning Signs which, if recognised and acted upon, allow for the best chances of a business being able to resolve those issues threatening its ongoing viability.

(ii) Substantive Warning Signs indicate that a business has serious cash flow issues which need to be addressed immediately.

(iii) Critical Warnings Signs indicate that the winding up of the business is imminent..

An appropriately qualified insolvency professional engaged when early warning signs are apparent gives directors and business owners' more options.

Set out below are the warning signs referred to above.

3.1 EARLY WARNING SIGNS

These signs are commonly displayed by businesses as they begin experiencing financial difficulties. These early warning signs include:

(i) An occasional inability to meet suppliers' debts within trade terms resulting in increased dialogue with suppliers.

(ii) Using cash reserves, such as funds set aside for GST, PAYG or superannuation, to cover temporary cash shortages.

(iii) Reduction in discretionary spending such as stationery, maintenance or staff amenities in order to maintain profitability.

(iv) Increased use of personal credit cards to pay business expenses.

(v) Deteriorating relationship with the bank as it starts to monitor a business more closely.

(vi) Inability to obtain mainstream finance as the banks have identified an increased risk of insolvency.

(vii) Increased level of worry about a business' financial circumstances.

(viii) Accumulated trading losses eroding a business' working capital.

(ix) Non-collection of debtors leading to temporary cash flow shortages.

(x) Legal disputes with external stakeholders or disagreements with other directors or shareholders.

(xi) Inability to quickly adapt or "pivot" to industry or regulation changes, new competition, natural disaster etc.

(xii) Delaying 'non urgent' expenses such as training, machine maintenance or key asset replacement to save costs.

(xiii) Avoiding engaging a professional for advice due to the costs of same.

It is worth noting that there may be no cause for alarm if it is considered that the problems are temporary in nature, and if steps are being taken to address issues if needed.

3.2 SUBSTANTIVE WARNING SIGNS

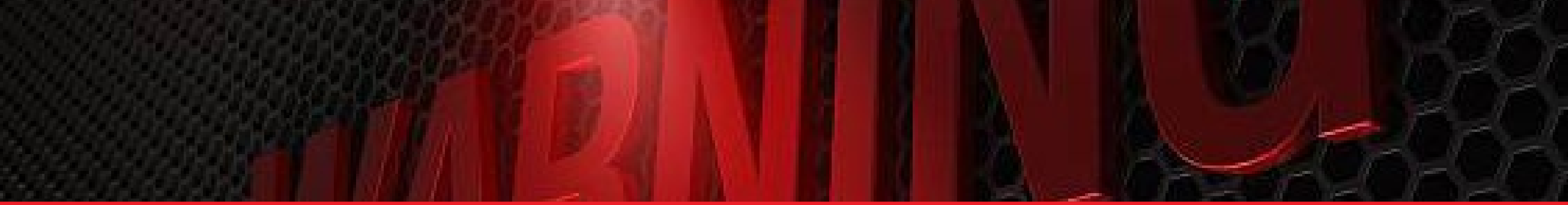
As a transitional measure, from 1 January 2021, eligible as the financial circumstances of a business further deteriorate, the indicia of insolvency become more obvious, and begin to have an increasingly detrimental impact on the business.

These substantive warning signs are:

(i) An inability to obtain finance from alternate/bridging financiers.

(ii) Suppliers placing customers on stop supply or COD terms and/or seek to reduce the credit limit on trade accounts.

(iii) An inability to avoid making payments outside of trade terms, having dishonoured payments, issuing post-dated cheques or making round dollar payments in response to specific demands for payment from a supplier.



(iv) Requirement to negotiate formal payment plans in order to secure ongoing supply or to prevent legal enforcement commencing.

(v) The inability to pay superannuation on time.

(vi) Delaying statutory lodgments such as BAS or Payroll Tax to attempt to defer cash outflows.

(vi) Reduction in staff numbers to save costs as the business cannot fund itself.

(vii) Choosing to ignore communications with creditors generally.

(viii) Staff members or internal financial controllers expressing concerns about a business.

(ix) Inability to prepare timely and accurate financial information, and a lack of records generally.

(x) Increased level of worry about a business resulting in family or marital issues.

(xi) Denial of, or avoidance of dealing with, the financial difficulties of the business.

(xii) Directors or business owners cease paying themselves a regular wages believing that they will make it up 'when things improve'.

If a number of these signs are identified, then it is likely that immediate action is warranted to ensure the survival of the business.

3.3 CRITICAL WARNING SIGNS

When the financial position of a business becomes sufficiently impaired, creditors will look to enforce the amounts due by that business. Critical signs of insolvency indicate that creditors will no longer wait for the circumstances of a business to improve and will generally initiate formal recovery action in order to obtain payment. These critical warning signs include:

(i) Legal demands for payment from creditor's solicitors.

(ii) Commencement of court action to recover amounts owed by a business.

(iii) Writ's for possession of property or garnishee notices being issued against a business.

(iv) Creditor's Statutory Demands or Bankruptcy Notices being issued against a business.

(v) Director Penalty Notices being issued by the ATO or Revenue NSW.

(vi) Repossession of business assets by secured creditors.

(vi) Winding Up proceedings or Creditor's Petitions being filed against the business.

(vii) Heavy reliance on government assistance schemes or grants to meet the day to day costs of running the business.

4 CONSEQUENCES OF INSOLVENCY

Sole traders are personally liable for the debts of their businesses and may be made bankrupt as a result of their failure to satisfy outstanding liabilities. Directors of insolvent companies risk personal liability through a range of exposures such as non-lodgment of PAYG and superannuation liabilities, director penalty notices from the ATO or Revenue NSW, or through claims by a liquidator for trading whilst insolvent.

Other issues may arise such as the calling up of debit loan accounts, or the triggering of liabilities under personal guarantees provided to third parties. Directors may also be held liable for breaches of their duties, particularly in respect of their conduct at a time when the company was insolvent. Both civil and criminal sanctions can be imposed against directors for breaches of duties.

O'Brien Palmer has previously issued articles which are available on the O'Brien Palmer website in which the consequences of insolvency for directors are explored, particularly in relation to;

(i) Director Penalty Notices issued by the ATO.

(ii) Revenue NSW Grouping provisions.

The consequences of the foregoing can be quite serious, and as such it is recommended that where warning signs of insolvency have been identified, then directors should seek immediate professional and experienced advice.

5 CONCLUSION: THE NEED FOR TIMELY ACTION

The warning signs set out above are not exhaustive, and not all of them will necessarily be present in an insolvent business. A business may also exhibit multiple warning signs and not necessarily be insolvent.

However, a business that transitions from showing early warning signs, to numerous substantive warning signs, is more than likely insolvent, or will be in the very near future. A business that exhibits any critical warning signs is most likely already insolvent, and has in all probability been so for some time.

Business owners and directors should be concerned when a business begins to show early signs of insolvency. However, as noted earlier, there may be no cause for alarm if the issues are considered to be under control. Pre-emptive action usually results in a broader array of options remaining available to the business than in circumstances where the finances of the business have been neglected.

Directors and business owners should remain cognisant of the warning signs of insolvency, and seek appropriate advice as soon as any of the warning signs are identified. A solvency checklist is available here on the O'Brien Palmer website as an additional resource available to be used when undertaking such assessments.

CONTACT THE OBP TEAM

SYDNEY
Level 9, 66 Clarence Street
Sydney NSW 2000

☎ (61) 2 9232 3322
✉ obp1@obp.com.au

BATHURST
103 Piper Street
Bathurst NSW 2795

PO Box 2153
Bathurst NSW 2795

☎ (61) 2 6338 2650
✉ obp1@obp.com.au

O'BRIEN PALMER
INSOLVENCY & BUSINESS ADVISORY