

We welcome you to the latest edition of our newsletter, in which we explore in a practical way the subject of solvency.

We hope you find the following of interest. Should there be other insolvency related issues that you wish to see covered in future editions, then please let us know by return email, as this will assist in keeping our topics relevant to readers.

## SOLVENCY

Corporate advisors will often need to consider the issue of solvency, not only in relation to refinancing or restructuring to rectify an existing problem, but also in relation to the serious matter of directors duties and the risk of personal liability; whether it be as a result of breaches of the Corporations Act, notices issued pursuant to Section 222AOE of the Income Tax Assessment Act or some other basis. So what is solvency and how do you determine whether or not a company is either solvent or insolvent?

The starting point is to refer to the Corporations Act for definitions. Section 95A defines a solvent person as being one who can pay his debts as and when they become due and payable. The definition of an insolvent person is no more than one who is not solvent. Unfortunately the usefulness of these definitions is limited and for further guidance it is necessary to refer to case law.

This firm was involved in one of the leading cases in the area; Southern Cross Interiors Pty Limited (In Liquidation) & Anor v The Deputy Commissioner of Taxation (2001) 188 ALR 114 at 214-5. In his Judgment, His Honour Palmer J. stated that the following propositions could be drawn from the established authorities:

- A company's solvency is a question of fact to be ascertained from considering it's financial position as a whole.
- In considering a company's financial position as a whole, the Court must have regard to relevant commercial realities, such as what resources are available to a company to meet it's liabilities as they fall due.
- In assessing solvency, it is proper to have regard to the commercial reality that creditors will not always insist on payment strictly in accordance with their terms of trade but that does not constitute a credit resource available to the company.
- The commercial reality that creditors will normally allow some latitude for payment of their debts does not warrant a conclusion that the debts are not payable at the contracted time.
- In assessing solvency, the Court acts upon the basis that a contract debt is payable at the time stipulated for payment in the contract.

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These propositions, whilst informative, are somewhat broad. A further and useful commentary on solvency was given by His Honour Mandie J. in a Judgment delivered in the high profile case of the ASIC v Plymin & Anor (2003) 46 ACSR 126 at 214-5, otherwise known as the Water Wheel case. Justice Mandie, after considering the legal tests of insolvency including the propositions set out by Justice Palmer, made reference to a checklist of indicators of insolvency, paraphrased as follows:

- Continuing losses.
- Liquidity ratios below one.
- Overdue Commonwealth and State taxes.
- Poor relationship with present Bank, including inability to borrow further funds.
- No access to alternative finance.
- Inability to raise further equity capital.
- Suppliers placing (company) on COD, or otherwise demanding special payments before resuming supply.
- Creditors unpaid outside trading terms.
- Issuing of post-dated cheques.
- Dishonoured cheques.
- Special arrangements with selected creditors.
- Solicitors' letters, summons(es), judgments or warrants issued against the company.
- Payments to creditors of rounded sums which are not reconcilable to specific invoices.
- Inability to produce timely and accurate financial information to display the company's trading performance and financial position, and make reliable forecasts.

Using the foregoing as a basis, exactly how do you determine whether or not a company is solvent? In his book titled Principles of Corporate Insolvency Law, 2nd Edition (1997 p67-9), Goode refers to two primary tests, namely the balance sheet test and the cash flow test. The former supposedly refers to absolute insolvency and is said to occur when a company's assets are insufficient to discharge its liabilities. The difficulty with the balance sheet test is that it is unreliable in that a company can be "asset rich" and technically insolvent or conversely, "asset poor" and technically solvent. For this reason and in light of the guidance given by the Courts, the balance sheet test is largely irrelevant. However in saying this, it is common practice for work undertaken on solvency to commence with an analysis of the available financial statements before moving to the cash flow test and other evidence, some of which may overlap.

## **ANALYSIS OF FINANCIAL STATEMENTS**

The analysis of a company's financial statements will provide an overview of the financial position of a company at a given date and provide prima facie evidence of solvency. The analysis would normally concentrate on the following:

- The net asset position which may require adjustment to take into account, for example, over or under valued assets, bad debts not provided for, off-balance sheet items or the elimination of intangible assets such as goodwill. A deficiency or nominal surplus could indicate potential insolvency.
- The working capital position. Once again, any deficiency in working capital or a working capital ratio of less than one could indicate insolvency.
- The extent of financial support from related entities and whether that support will be continued.
- The ageing of creditors would indicate whether Commonwealth and State taxes and trade creditors are overdue.
- Any significant increase in creditors could indicate funding from that source and a potential cash flow problem.
- Poor trading performance or trading losses which over time will inevitably impact upon cash flow.

### **THE CASH FLOW TEST**

In his Water Wheel Judgment, Justice Mandie referred to the Section 95A definition of solvency as "the so-called cash flow test". As the name implies, the test centres on a company's liquidity; that is, whether or not there are sufficient resources available to a company to meet its debts as and when they fall due for payment. In order to assess the cash flow position, it will be necessary to take into account certain information obtained from the analysis of the financial statements, for example, the ageing of creditors and basically prepare a cash flow statement by undertaking the following:

- Reviewing cash availability by reference to cash at bank, unused finance facilities, sales, debtor receipts, asset sales etc.
- Reviewing cash requirements by reference to creditor payments including overdue amounts, monthly business outgoings such as wages, finance repayments etc.
- Determining the extent of any shortfall in cash flow and whether it can be covered by the raising of additional finance, an injection of capital, loans from related parties etc.

It follows that any resulting cash deficiency would be evidence of insolvency as would the inability to raise monies to eliminate that deficiency.

### **OTHER EVIDENCE**

Meeting with the directors and reviewing a company's records will reveal further evidence of solvency. The areas of enquiry might include the following:

- Reviewing the company's minutes of meetings.
- Ascertaining whether the company has COD arrangements with suppliers.
- Determining whether any negotiated payment arrangements exist with creditors.
- Reviewing banking records for post-dated cheques, the withholding of cheques and dishonoured cheques.

- Reviewing creditor records for letters of demand, solicitor's letters, judgments, Section 459 Statutory Notices etc.
- Reviewing any legal proceedings that may be on foot.

## THE ASIC

You will be aware that in July 2003, the ASIC established the National Insolvent Trading Program for the purpose of addressing possible insolvent trading before it occurs and to change the perceived culture existing amongst company directors of denial of financial difficulty. It involves a review of a company for the purposes of ensuring compliance by directors of their duty of care as set out in Section 180 of the Corporations Act and their duty to prevent insolvent trading pursuant to Section 588G of that Act. During the first year of operation, the ASIC conducted nationally 649 company surveillance visits, 71 of which later appointed a Voluntary Administrator. As part of its work, the ASIC has identified some key operational and financial practices that may put a company at risk of becoming insolvent. These practices are risk factors only and include the following:

- The loss of key management personnel.
- Disorganised internal accounting procedures.
- An absence of budgets and corporate plans.

## CONCLUSION

The difficulty directors face is firstly knowing when the company they control is insolvent or about to become insolvent and secondly accepting the fact that the company is or may become insolvent. In many cases determining whether a company is insolvent can be quite simple. However it is not an exact science and in certain circumstances the issues can be complex, especially when an attempt is being made to determine particular dates at which a company was or became insolvent. The issue of solvency is one that will continue to grow in importance and as time moves on the Courts will no doubt provide further guidance for directors and their advisors.

If you require further information regarding any insolvency related issue, then do not hesitate to contact us.

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