SOLVENCY AND GOING CONCERN

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Assessing solvency and assessing going concern are separate tests that have their own specific criteria. In general the question of solvency is whether an entity will be able to pay its debts as and when they become due and payable. This shouldn't be confused with liquidity, which is the ability to pay current liabilities with current assets. Both liquidity and solvency are important concepts as they both measure the ability of an entity to pay its debts, albeit liquidity has a short-term focus and solvency considers longer-term obligations. An entity is considered to be a going concern unless management either intends to liquidate the entity or to cease trading, or has no realistic alternative to liquidation or cessation of operations. Definitions can vary in law and also by accounting practice applicable to the entity.

Most importantly, it is possible for an entity to be solvent but not a going concern and vice versa. There can be situations which result in insolvent trading not being an offence and indeed the UK government enacted emergency legislation during the coronavirus pandemic which allowed some relaxation in the rules surrounding wrongful trading. Conversely, there may be cases where some entities are insolvent but a going concern. For example, there may be circumstances where a business is fundamentally

sound, has forbearance from its lenders, and is able to continue to trade despite being unable to pay suppliers within normal credit terms or meet its debts in the short term. However, as some recent high-profile cases have demonstrated, directors should exercise caution and consider the need to seek appropriate professional legal and financial advice in relation to uncertainties around solvency and going concern.

Solvency

Solvency refers to a business's long-term financial position. A solvent business is one that has positive net worth. That is, its total assets are more than total liabilities. Solvency is most commonly assessed using solvency ratios, which measure the ability of the business to pay off its long-term debts and interest on its debts. Such ratios included interest coverage ratio and debt-to-equity ratio amongst others.

If directors are required to declare solvency in a solvency statement, this generally means 'Does the company have capacity to pay debts which it has incurred as at the time of that declaration?' Directors should also take into account debts which will be incurred in the foreseeable future. Under UK law, directors must have reasonable grounds for believing that the company will be able to pay its debts as and when they fall due. In meeting the reasonable grounds requirement, directors should consider all information relevant to forming their opinion in respect of the solvency statement such as:

- profit and loss forecasts and budgets;
- cash flow budgets including cash balances or overdrafts, the amount and timing of operating cash flows, access to credit lines and undrawn facilities, and the liquidity of non-core investments;
- the timing and amount of payment obligations, supplier credit terms, debt repayment dates, and the end date for any loan repayment or rent holidays, including expected dates for repayment of loans where no repayment dates have been fixed or agreed;
- the ability of customers and borrowers (including related parties) to meet their obligations to the company, including meeting credit and repayment terms;
- the ability to realise current assets such as receivables and inventory;

- known or likely changes in economic and market conditions, consumer behaviours and demand, inventory turnover, supply chains, production processes, and ability to deliver goods and services;
- ability to comply with debt covenants and normal terms of credit, renegotiate debt arrangements, and refinance maturing debt;
- the possibility of withdrawal of financial support by major lenders, debt factoring arrangements, customer supply chain financing, or financial support by a parent company;
- ability of a parent company or shareholders to meet any financial support arrangements;
- the solvency of any entities to which the company has given financial guarantees or offers of financial support;
- the extent and timing of any government support and travel or other restrictions;
- any material contingent or prospective liabilities; and
- any uncertainties affecting the above.

Solvency and going concern key questions

The questions below cover either or both solvency and going concern, and are relevant depending on the type, size, and complexity of the entity.

Financial

1. Is there a net liability or net current liability position?
2. Are fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment?
3. Is there an excessive reliance on short-term borrowings to finance long-term assets?
4. Are there indications of withdrawal of financial support by creditors?
5. Are there any negative operating cash flows indicated by historical or prospective financial statements?
6. Are there any adverse key financial or solvency ratios?
7. Are there any substantial operating losses or significant deterioration in the value of assets used to generate cash flows?
8. How quickly is income converted into cash? Has there been any deterioration? If so, why has that happened?

9. Is there an increasing amount of receivables and what is the age profile? Is there any unallocated cash, and if so, does this indicate an underlying problem within the finance function or payments on account by debtors (or any other reason)?
10. Are there any arrears or discontinuance of dividends?
11. Is there an inability to pay creditors on due dates? Is there an increasing number of creditors and for how long have they been outstanding beyond the expected payment period? Has there been a change in credit terms? Is the age profile of creditors correct?
12. Is there an inability to comply with the terms of loan agreements?
13. If there are cash flow issues, are there any impacts for any other contractual covenants?
14. Is there any change from credit to cash-on-delivery transactions with suppliers?
15. Is there any inability to obtain financing for essential new product development or other essential investments?

Operating

16. Are there any management intentions to liquidate the entity or to cease operations?
17. Has there been any loss of key management personnel without replacement?
18. Has there been any loss of a major market, key customer(s), franchise, license, or principal supplier(s)?
19. What is the risk profile of new clients or contracts and is this a change from previous practice or agreed strategy?
20. Are there any workforce difficulties?
21. Are there any shortages of important supplies?
22. Is there any emergence of a highly successful competitor?

Other

23. If the entity is a financial institution is there any non-compliance with capital or other statutory or regulatory requirements, such as solvency or liquidity requirements?

24. Are there any threatened or pending legal or regulatory claims or proceedings against the entity that may, if successful, result in claims that the entity is unlikely to be able to satisfy?
25. Are there any changes in law or regulation or government policy expected to adversely affect the entity?
26. Are there any uninsured or underinsured catastrophes when they occur?
27. Has there been a substantial decrease in share price?
28. Are there any off-balance sheet commitments or contingencies?

The significance of such events or conditions often can be mitigated by other factors. For example, the effect of an entity being unable to make its normal debt repayments may be counterbalanced by management's plans to maintain adequate cash flows by alternative means, such as by disposing of assets, rescheduling loan repayments, or obtaining additional capital. Similarly, the loss of a principal supplier may be mitigated by the availability of a suitable alternative source of supply. The key question is whether those mitigating factors are realistic, reasonable, timely, and capable of being implemented.

Management's assessment of solvency and/or going concern

In many large organisations, management will draft a detailed assessment of solvency and/or going concern. However, it is important to be aware of limiting behaviours in assessing solvency and going concern such as over-optimism, arrogance, confirmation bias, lack of systemic thinking, or even the challenge of complexity. Key questions which may be applicable include the following:

1. Are the processes to produce supporting information underlying solvency or going concern assessments reliable?
2. Is the information provided consistent with your understanding of the business, the markets in which the company operates, and any other relevant matters?
3. Are the underlying assumptions reasonable? For example, if the business needs further cash or additional funding, have management considered how or where it can be accessed? What assumptions

underlie this and are those assumptions reasonable? Have they been stress-tested? If so, how?

4. Is the range of judgements underlying the assessments too optimistic?
5. How has management considered the impairment of any goodwill and what key judgements underline that assessment? Are those judgements and assumptions consistent with those underlying the assessment of going concern?
6. Is the business model or any part of it flawed. For example, does the entity make a profit or sufficient profit but produce insufficient cash flow? If profit margins are in decline but cash flow improved, does this make sense?
7. Has the business built in any resilience? That is, would it be a going concern under various adverse scenarios? Have those adverse scenarios been stress-tested? If so, how?
8. What is the risk of failure to deliver plans to address any adverse scenarios? Is management able to transform plans into actions if required? What oversight does the board have and is there any follow-through in decision-making which can be undertaken?
9. Is the business prepared for assumptions to be upturned, for example its projected debt refinancing to be unsuccessful? What are the contingency plans and are they realistic? Can they be executed in a timely fashion and what are the obstacles?
10. In terms of challenging the existing assumptions, is there any information that would cause management to change assumptions? If so, what would that information be?
11. Has the business established any early warning indicators for solvency and going concern?
12. Is the business model sustainable? Perhaps only if debts are “taken away”?
13. What’s the safety margin and is it mapped and tracked over time?
14. In respect of any tax, legal, or regulatory uncertainties, are there any contingency plans?
15. What is management and/or the board blinded to?
16. Has there been any bad news, and how have the board and management dealt with it?
17. Has management imagined future failure and considered what the warning signs would have been?

On a final note, it's important to note that the risk of insolvency or failing to be a going concern can never be fully controlled or mitigated. Considering an "off-piste" – skiing analogy – one can carry equipment and be prepared for an avalanche, but you can't reduce the risk of an avalanche occurring. However, you can monitor the weather and snow conditions and adapt accordingly. In summary, you can look for the warning signs of an event about to happen and build in resilience to weather the event.