INSOLVENCY

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Solvency for a company is the degree to which its assets exceed its liabilities. Solvency can also be described as the ability of a company to meet its financial obligations and to achieve long-term expansion and growth.

Solvency is generally an important measure of financial health since it is one way of demonstrating a company's ability to manage its operations into the foreseeable future. The quickest way to assess a company's solvency is by checking the equity/value on the balance sheet, which is the sum of a company's assets minus liabilities. An alternative test is the availability of liquidity to meet financial obligations as they fall due.

There are also solvency ratios, which can spotlight certain areas of solvency for deeper analysis.

Many companies experience periods with a negative balance sheet value or an unhealthy quick ratio (liquid assets surplus over current liabilities), which could be signs of insolvency.

A negative balance sheet indicates that a company has impaired shareholders' equity, and this can lead to losses for creditors, business owners, and personal claims against directors. In essence, if a company was

required to immediately close down, it would need to liquidate all of its assets and pay off all of its liabilities, leaving only the shareholders' equity/balance sheet net assets as a remaining value.

Certain events may create an increased risk to solvency, which are key for directors to be aware of and closely updated by the executives. Events like a pandemic, or other unforeseen natural disasters such as flooding or unusually bad weather, can significantly influence the solvency of businesses. The world has been a witness to that during the Covid-19 pandemic, and the impact of climate change is also giving ongoing live examples of the impact it has on the solvency of many businesses.

In addition, changes in laws and regulations can quickly have a negative impact on solvency and rapidly move an organisation towards insolvency. When changes in certain regulations directly impact a company's ability to continue business operations, directors have to act swiftly and keep a very close eye on the solvency situation of the company. Brexit is a good example of a decision that could have widespread impact on many businesses by introducing changes to laws and regulations. It takes businesses a relative long time to change the ways they conduct business, and some are not agile enough to survive widespread changes or sudden shocks and therefore fall into insolvency.

When directors consider whether a company is at risk of insolvency, it is also important to be aware of certain measures used for managing liquidity. Solvency and liquidity are two different things, but it is often wise for directors to look at them together, particularly when a company is potentially insolvent. A company can be insolvent and still generate positive cash flow as well as steady levels of working capital.

While solvency represents a company's ability to meet all of its financial obligations, generally the sum of its liabilities, liquidity represents a company's ability to meet its short-term obligations. This is why it can be especially important to check a company's liquidity levels if it has a negative net balance sheet value/is balance sheet insolvent.

One of the easiest and quickest ways to check on liquidity is by subtracting short-term liabilities from liquid short-term assets (quick ratio). This is also the calculation for working capital, which shows how much money a company has readily available to pay its upcoming invoices/creditors. A company can survive while insolvent for a reasonable time period, but a company cannot survive without liquidity.

Independent business review

If directors find themselves in a situation where a company appears close to entering a distressed or insolvent state, they should consider appointing an external adviser to conduct an independent business review. An external stakeholder, such as the bank or investor, can also call for such a review, which is usually undertaken at the expense of the company. This generally happens when the bank or investors are concerned that the information flow from management is not fit for purpose, or the underlying risks are high so they commission experts in insolvency and finance to establish the solvency and viability of the company.

The adviser should independently assess the business recovery plan the board and executives are proposing to avoid insolvency and determine if the proposed actions are realistic. Sometimes it can be hard for executives and directors to look at the situation at hand from all angles and with the required objectivity.

If directors/stakeholders initiate an independent business review, the directors need to be prepared to provide a range of information. The required information is nothing beyond what should be readily available from any well-run company. It will generally result in a comprehensive report on the company, its business, and its management. The executive management team will be required to take part in the review but may not be part of the final report to the board and/or key stakeholders. This report can also lead to further protective steps, utilising business rescue insolvency tools, to protect creditors.

The below non-exhaustive list shows what an independent business review can include:

- Trading and financial position analysis
- Market place and competition
- Balance sheet and asset values
- Overall risk analysis across the company
- Cash flow projections analysis
- Business strategies/business plan analysis
- Plan for recovery, SWOT analysis
- Management abilities and skills/skill gaps

- Sensitivity analysis on all forecasts
- Corporate structure
- Bank covenants and how they will be met
- External valuation of assets

Red flags to be aware of as directors and stakeholders

It is common for companies to have to cut costs from time to time. However, if a company is tightening its belt excessively in one or more of the below mentioned scenarios, it could be a red flag:

Reduced cash and/or losses – a company that loses money month by month could burn through its available cash quickly.

Debt covenants – at risk of breaching covenants, do the company's revenues generate enough cash to service current debt?

Switching auditors – a sudden change in auditors for no apparent reason will raise a red flag with stakeholders. It can be a sign of a disagreement over the accounts or a conflict with the executives.

Dividend cut – dividend payments to shareholders are usually one of the first items to be looked at in a difficult situation. A board is not likely to cut dividends unless absolutely necessary as it will generally affect the share price/valuation of the company.

Executive team resignations – typically when times are difficult, senior members of the executive management team will leave to take a job at a different company.

Selling assets – a company will generally only sell valuable assets in a situation where they need to raise cash.

Cutting staff benefits – many companies will seek to make cuts to various benefits in difficult times.

The most important thing to do as a director in a difficult situation is NOT to do nothing and NOT to panic. Keep in mind that in an insolvency, directors have a duty to the creditors, not themselves or the shareholders. Therefore, the first thing to do is establish whether the company is insolvent or on the road to becoming so. If directors believe it is, then directors must act to ensure that the creditors' situation is not made worse.

Below are a range of questions that directors should consider asking in a situation where they are concerned with the solvency of the company they serve on the board of:

- What is the definition of insolvency in the jurisdictions the entities are registered and/or operate in?
- What are the fiduciary and other statutory duties of the board?
- What are the individual responsibilities of a director and the collective responsibilities?
- How do the board's duties and duty of care shift from shareholders to creditors as the entity moves through the insolvency curve?
- When is the tipping point after which the board's prime duty of care switches from shareholders to creditors?
- What steps should the board be taking to avoid an insolvency?
- How should the board deal with matters impacting the potential outcome for creditors?
- How should the board deal with shareholders in the run-up to an insolvency event?
- How should the board deal with secured creditors and senior-ranking creditors?
- How should the board deal with other stakeholders, including employees and government?
- Should the board preferentially treat any creditors who rank as a similar class of creditor?
- Are there any further factors for the board to consider in relation to ransom payments and/or critical creditors?
- How often should board meetings be held and should any special processes be adopted at meetings?
- How should the board deal with taking on new credit or extending credit terms?
- How should the board deal with taking cash in advance from customers before supply of services?
- What type of contingency plans should be created by the board facing an insolvency event?
- When should a board consider that the point of no return has been reached and they should throw in the towel?

- What advice should the board be receiving from qualified professionals and when should this be commissioned?
- What investigations into the affairs of the company and conduct of directors are undertaken in insolvency?
- What happens to the role of the board on the appointment of insolvency practitioners?