

WHAT IS INSOLVENCY ?

Overview

The definition of insolvency found in the Corporations Act 2001 (s.95A(2)) is not particularly helpful, “A person who is not solvent is insolvent”. The issue of solvency then is the key to determine whether a person or entity is insolvent or not. To simply say that solvency exists when the person or entity is able to pay its creditors as and when their debts are due fails to take into consideration the normal circumstances and environment that business’s operate within.

Operational Issues Regarding Solvency

To fully address the issue of solvency it may be necessary for the directors of an organisation to look at the overall cash flow environment. The following specific points could be salient:

- The cash assets of the business when debts are due to be paid
- Identifying working capital needs / requirements
- Funding sources that may be readily available
- Short term borrowing arrangements or lines of credit
- Time frames for creditor payments or new terms of credit
- Debtor schedules, ageing and historical reliability of payments received
- Liquid assets that are legitimately able to be sold

Justice Finkelstein stated in *Quick v Stoland* (1998) 157 ALR 615 that, “The inquiry whether there are reasonable grounds to expect the company will not be able to pay its debts when due is a factual one to be decided in the light of all the circumstances of the case. It is to be decided as a matter of commercial reality and thus requires a consideration of the company’s financial condition in its entirety, including its activities, assets, liabilities, cash, money that it could procure by sale of assets or by way of loan and its ability to raise capital.”

It can be seen from the above that a simple calculation of net assets would be insufficient to determine insolvency.

Indicators of Insolvency

ASIC have quite a few documents available to directors, creditors and other interested parties to help identify warning signals that may be indicating that a business is heading towards insolvency. The following are some points that ASIC advise are issues that should be monitored to ensure that a business is not at risk of insolvency:

- poor cash flow, or no cash flow forecasts;
- disorganised internal accounting procedures;
- incomplete financial records;
- absence of budgets and corporate plans;
- continued loss making activity;
- accumulating debt and excess liabilities over assets;
- default on loan or interest payments;
- increased monitoring and/or involvement of financier;
- outstanding creditors of more than 90 days;
- instalment arrangements entered into to repay trade creditors;
- judgement debts;
- significant unpaid tax and superannuation liabilities;
- difficulties in obtaining finance;
- difficulties in realising current assets (e.g. stock, debtors);
- loss of key management personnel.

Further information may be found at

<http://www.asic.gov.au/asic/ASIC.NSF/byHeadline/Insolvency%20information%20for%20directors>