G-Corporate Advisory

"Financial stress in organisations: The broader perspective of signs and symptoms."

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INTRODUCTION:

There are literally countless articles, publications, texts, papers, theses and case law describing financial stress and symptoms in organisations. This article intends to summarise those areas but also highlight signs and symptoms which are often completely ignored by Directors/Owners ("Managers") of organisations.

Generally, the larger the organisation, the better the control mechanisms should be present to alert Managers of their financial position. For the purposes of this article, it will be assumed that the organisation is larger and therefore some of those principles can be transferred to organisations smaller in size or capitalisation base.

Financial stress and distress:

Unfolding the argument will commence by defining financial stress. We will firstly parallel the argument and proffer the definition of emotional stress? The Australian Psychological Society 2012 ("APA") defines stress as "…as a feeling of being overloaded, wound-up tight, tense and worried". This definition may be applied to financial stress. The legitimate non-payment of creditors on a timely basis would undoubtedly describe the availability of funds as "tight, tense and worrying" much like emotional stress. When emotional stress transforms to distress, then according to the APA, it "…interferes with our ability to get on with our normal life for too long.". Similarly, for an organisation to experience financial distress, it cannot get on with its normal organisational life. After all, what is the difference to the social and physical sciences between the term 'organisation' and an 'organism'? There is nothing illegal for an organisation to experience signs and symptoms of financial stress but the issue inflames when the financial ***stress*** becomes financial ***distress***; a clear separation of platforms between the two.

The signs and symptoms of financial stressors:

Signs and symptoms in organisations experiencing financial stress are multifactorial; often crossing-over other areas in the organisation.

If the financial position does not ameliorate, then the organisation risks insolvency but sometimes, deceitful and higher risk-taking Managers continue trading whist insolvent entering a legal nebula that traps them. Some organisations are all too familiar with the process and are experienced at manipulating insolvency and liquidation via their Lawyers, Accountants, Administrators/Liquidators or pre-administration Advisors. Other Managers perhaps will just ignore the signs and symptoms for whatever the reason(s). Keeping in mind the aforementioned arguments, financial stress signs and symptoms that organisations should be sensitive to include the following:

List 1:

(i) Any delay to the payment of wages and salaries;
(ii) Any delay to the payment of superannuation to staff;
(iii) Any delay to financial debt repayments;
(iv) Any delay to any taxation obligations to statutory bodies;
(v) Any delay for other statutory obligations such as land tax, property lease payments;
(vi) Any delay to legitimate and legal refunds for any faulty product or service towards clients and customers;
(vii) Any delay to payments to accountants, lawyers and other organisational advisors;
(viii) Costs exceeding budgets;
(ix) Income(s) not achieving budgets;
(x) Salaries (inc. Super/benefits) that are proportionately high to income revenue streams;
(xi) Various specific ratio analyses that relate to liquidity & stock turnover;
(xii) Breach of financial and other credit covenants;
(xiii) Cash flow generally such as relying on Goods and Services Tax (or value-added tax) credits to fund operations.

It may well be the case that some Readers of this article at this point, will argue that the delay of payments is also to maximise their cash flow periods and allow those delays as a source of informal internal funding for the organisation. Perhaps so. It could also be a case of ineffective management operating in an organisation without sufficient level of controls. However, those behaviours can be received in different ways by creditors and Managers need to reflect at what potential cost, squeezing payment terms from the creditors will impact on their own goodwill and good name. You should know that these behaviours can in fact attract adverse behaviours from your business partners or creditors. Certainly, creditors and debtors often squeeze their payment terms during economic downturns where customers and clients are scarcer. It is also true to say that some 'enjoy' the game of delaying payments. Again, what perceptive signals do these behaviours portray to outside organisations about the state of your organisation's financial affairs; not to mention, your good standing (if you have any).

Insolvency considerations:

The statutory definition of insolvency under S95A (1) of the Corporations Act is tested as "A person is solvent if, and only if, the person is able to pay all the person's debts, as and when they become due and payable." The term person does include a body corporate. The Australian Securities and Investments Commission ("ASIC") provide their opinions of signs and symptoms when considering the risk of insolvent trading:

List 2:

(i) ongoing losses;
(ii) poor cash flow;
(iii) absence of a business plan;
(iv) incomplete financial records or disorganised internal accounting procedures;
(v) lack of cash-flow forecasts and other budgets;
(vi) increasing debt (liabilities greater than assets);
(vii) problems selling stock or collecting debts;
(viii) unrecoverable loans to associated parties;
(ix) creditors unpaid outside usual terms; *
(x) solicitors' letters, demands, summonses, judgements or warrants issued against your company;
(xi) suppliers placing your company on cash-on-delivery (COD) terms;
(xii) issuing post-dated cheques or dishonouring cheques;
(xiii) special arrangements with selected creditors;
(xiv) payments to creditors of rounded sums that are not reconcilable to specific invoices;
(xv) overdraft limit reached or defaults on loan or interest payments;
(xvi) problems obtaining finance;
(xvii) change of bank, lender or increased monitoring/involvement by financier;
(xviii) inability to raise funds from shareholders;
(xix) overdue taxes and superannuation liabilities;*
(xx) board disputes and director resignations, or loss of management personnel;
(xxi) increased level of complaints or queries raised with suppliers;
(xxii) an expectation that the 'next' big job/sale/contract will save the company.

The items in List 2 presented by ASIC could potentially appear at different and concurrent stages during an organisation's financial demise and ASIC's list somewhat can confuse Readers. The items for example, marked (*) could well appear very early in the organisation as it starts to experience financial stress but they are not necessarily signs of insolvent trading. The ASIC makes no distinction on this differential and is deficient in delineating the specific differences. Further, the 'absence of a business plan' (iii) is not evidence of insolvency and nor is a 'disorganised accounting internal system' (iv) but rather, incompetent or mismanagement that, as part of a number of other actions or inactions, could have lead the organisation to insolvency.

Once the organisation enters the stage of financial distress, unless substantive and affirmative action is taken, the probability of the need to appoint Administrators increases considerably. Beaver, W (1966) defined financial distress as "bankruptcy, insolvency, liquidation for the benefit of a creditor, firms which defaulted on loan obligations, or firms that missed preferred dividend payments. Beaver's technique accurately classified 78% of the sample companies five years prior to failure. Beaver's research concluded that the cash flow to debt ratio was the single best indicator of bankruptcy",. (Muller, G; Steyn-Bruwer, B et al, 2012). Muller, G et al (2012) state, "that there is a lack of consensus" in defining financial distress. They also state that, "other researchers define financial distress as mergers, absorptions, delisting or liquidations or major structural changes to the company" (2012). One could not be at fault for considering the aforementioned definition of financial distress as somewhat excessive exchanging the terms 'financial distress' and 'mergers, absorptions, delisting or liquidations' as synonyms. Their definition of financial distress convincingly suggests that an organisation has no escape once it has entered this phase but this is not the case at all; albeit the balance of probabilities suggests that it is.

One of the most notable legal cases for the test for insolvency is Quick v Stoland Pty Ltd (1998) 157 ALR 615.

His Honour Justice Emmett said, "In order to determine whether the company was solvent at a given time, it would be relevant to consider the following matters:

- All of the company's debts as at that time in order to determine when those debts were due and payable;
- All of the assets of the company as at that time in order to determine the extent to which those assets were liquid or were realisable within a timeframe that would allow each of the debts to be paid as and when it became payable;
- The company's business at that time in order to determine its expected net cash flow from the business by deducting from projected future sales the cash expenses which would be necessary to generate those sales;
- Arrangements between the company and prospective lenders, such as its bankers and shareholders, in order to determine whether any shortfall in liquid and realisable assets and cash flow could be made up by borrowings which would be repayable at a time later than the debts."

His Honour also made reference to two other factors regarding the test for insolvency:

"It is often accepted, as a rule of thumb, that a company will be regarded as insolvent if its current liabilities exceed its current assets. However, that cannot be more than a rule of thumb. A company might satisfy that requirement yet it may be shown, on a more careful analysis, not to be able to pay its debts as and when they become due. Equally, a company may fail that test but still be able to demonstrate that it can pay all its debts as and when they become due and payable. "Further a deficiency of total assets to total liabilities is not conclusive as to insolvency. A company could have a deficiency of net assets yet, because of a very strong profit making business, be in a position to pay all its debts as and when they become due and payable. That is to say, even if a net asset deficiency exists reasonable projections may indicate that the company would generate sufficient profit to be able to eliminate that deficiency before the long term debt becomes due and payable. The company would be solvent in those circumstances."

Within the same case, His Honour Justice Finkelstein J, stated,

“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”.

Also crucial to the determination of insolvency is to determine at what point of the organisation’s financial demise when insolvency did identify itself. Conclusively, limiting the signs and symptoms of financial stress can be short-sighted. Validation and triangulation should prevail in all instances when making those assessments.

Profit & loss versus cash flows:

In a past consultancy assignment for a very successful and wealthy client, I had difficulty convincing a client that profit & loss is not the same as cash flow. It just brought to fruition that sometimes financial success is more as a result of ‘good luck’ than ‘good management’. Profit & loss and cash flow are not interchangeable. Briefly, cash flow relates to funds coming in and going out of an organisation and does not include depreciation and other non-cash items. Even so, cash flow and profit & loss measures have timing differences. Therefore, if you believe that your organisation is making a profit, you should also consider your cash flow to ensure you are able to meet your financial commitments. Conclusively, imminent signs of cash flow deficiencies are indicative of financial stress and the degree of those deficiencies, will determine if the financial stress progresses to financial distress or further still, to Administration, Liquidation and/or Bankruptcy.

Conclusion:

There are several measures to determine whether your organisation is experiencing or starting to experience financial stress. There are some noteworthy points however, to consider and to be sensitive to when attempting to assess the current financial status of your organisation:

1. Is the organisation experiencing early signs of financial stress with some of the symptoms described (not exhaustive) in List 1?;

2. Has the organisation commenced exhibiting other more definitive and serious signs of financial stress and moving to a position of financial distress?;

3. Has the organisation’s financial position gone beyond the point of financial distress to a stage where insolvent trading has now set in?;

4. Does the organisation need to seek an independent assessment prior to their financiers imposing a purpose report for their review?;

5. What are the immediate remedies and reliefs that can be applied to step down from financial distress to the lesser level of financial stress and bring back normality?;

6. Is it time to appoint Administrators?

Your organisation should have suitable and informative dash boards and decisive Managers to constantly monitor the financial position. Ignoring the signs and taking the risk beyond its level of its risk/return profile could not only be negligent but open the way for criminal and civil law suits.