Early Warning Signs of an Insolvent Company Fact Sheet

Early Warning Signs of an Insolvent Company Overview

There is no hard and fast rule in determining the insolvent state of a company, however, it is important to understand and be aware of the early warning signs of insolvency being:

1. Non-payment of Tax Liabilities and superannuation

A company will often forgo the payment of its tax liabilities to ensure that it has sufficient cash flow to meet its wages and critical supplier payments. In addition, companies experiencing financial difficulty may fail to pay superannuation obligations in respect of employees. These are key indicators of insolvency.

2. Continuing Losses

Ongoing losses over multiple reporting periods is a strong indication that a company is insolvent or may become insolvent. This is because a company must recoup prior losses from future profits. When profits are not being generated, then compounding losses will result in significant working capital deficiencies and insolvency. A mitigating factor may be a company's ability to fund losses through borrowings.

3. Liquidity ratios below one

The liquidity ratio measures a company's ability to satisfy its current liabilities from its current assets. A liquidity ratio below one indicates that the company does not have sufficient current assets to meet its current liabilities and is a key indicator of insolvency.

4. Continuing Negative Net Asset Position

A negative net asset position indicates that a company does not have sufficient assets to meet its liabilities and is what is known as balance sheet insolvency.

5. Inability to produce timely & accurate financial information

A company must keep financial records that record and present a true and fair view of the company's financial position and performance at any given time. An inability to produce accurate and financial information indicates that a company may be insolvent or may be presumed to be insolvent under the *Corporations Act 2001*.

6. Special arrangements with selected creditors

Entering into selected arrangements with certain creditors indicates that the company is having difficulty meeting its liabilities as and when they become due and payable. The company may be forced to do so to hold off legal action or to secure ongoing services or supply when credit terms are in default.

7. No access to credit or alternate finance

The poor relationship with a company's bank due to a history of loan defaults may result in a company losing the support of its lenders. An inability to obtain financing from alternative sources such as a different lender or shareholders indicates that the underlying business is not viable.

8. Outside trading terms with creditors and supply on Cash on Delivery ("COD")

When trading terms with creditors are well outside normal trading terms, i.e. 30–60 days and creditors are demanding that supply be made with COD.

9. Receiving demands and/or other legal notices

When creditors are pressing for payment in the form of final notices and issuing legal demands, it will not be long before they receive a judgment order for their debt and proceed with winding up proceedings.

10. Low stock turnover

When a company's stock is not moving and the majority of stock on hand is extremely old and in some cases, obsolete. This will affect the value of this asset that companies have recorded in the balance sheet and after adjustment of the stock value, a negative balance sheet position may result.

11. High Accounts Receivable, Inability to Collect Debtors

The debtors of the company not paying indicates that the company is not accurately recording debt due or properly assessing the collectability of those receivables. If debtor days increase it indicates that the company is not converting its debtors to cash to meet working capital requirements and may therefore be insolvent.

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