Audit and insolvency

From June 2011, the syllabus for Paper P7 (UK) and (IRL) includes specific learning outcomes relevant to auditing aspects of insolvency (syllabus reference E7). This topic has been added to the syllabus on the recommendation of the Financial Reporting Council's Professional Oversight Board in order to comply with the requirements of the Statutory Audit Directive, as the topic is considered required knowledge for those wishing to obtain the audit qualification and practice as an auditor.

Why should auditors need to understand aspects of insolvency? The simple answer is that, unfortunately, many auditors' clients will face financial distress at some point in their business lifecycle. The global economic recession of the past few years has caused many companies to face insolvency, and in times of crisis the directors of such companies may turn to their auditor for information and advice. Therefore, auditors must be in a position to determine the level of financial difficulty being faced by a client, explain and recommend the various options available to management, and explain the consequences of liquidation or administration.

This article highlights some of the issues that auditors may have to deal with in respect of insolvency. Of course, it is important to study this topic in its entirety using an up-to-date study text to gain full knowledge and understanding of this new syllabus area.

The meaning of insolvency

It is important to understand what is actually meant by a company being 'insolvent', and to distinguish insolvency from general, less severe financial difficulties. A company is insolvent if the value of its assets is less than its liabilities – in other words, the statement of financial position shows a position of net liabilities. If all of the company's assets were sold at book value, the existing liabilities could not be paid. This is a more fundamental problem than simply being short of cash.

Company directors are charged with monitoring financial position and performance. This is especially important when the company is experiencing financial difficulties, as a company experiencing cash flow problems can quickly turn insolvent. When a company is facing insolvency, the directors must consider the interests of creditors (payables), shareholders and other stakeholders, which is impossible to do without up-to-date financial information. Directors must, therefore, prepare and monitor financial statements and cash flow and profit forecasts on a regular basis in order to determine the financial position of the company. Auditors may be asked to advise on whether a company is insolvent, or to review historic or projected financial information. Having up-to-date financial information and taking professional advice may also help to protect directors from legal claims such as wrongful trading or misfeasance.

Options available

The directors of an insolvent company face a difficult decision. Should they continue to trade, in the hope that the company's performance and position will improve, or should they cut their losses and wind up the company? This is a dilemma that the auditor may be asked to help resolve by evaluating the advantages and disadvantages of the options available, and considering the impact of each on the relevant parties, including creditors, shareholders, management and employees. The auditor may also be asked to explain the procedures involved in placing a company into administration or liquidation, as directors will usually have limited knowledge in this area.

Administration

If the directors decide to try to save the company, it can be placed into administration, which offers some breathing space and legal protections while a rescue plan is formulated to try to preserve the company's going concern status. The main advantage of administration is that once an administrator is appointed, a moratorium over the company's debts commences meaning that it is not possible for a winding up petition to be presented at court by the company's creditors (payables) – thus allowing time for the rescue plan to be designed and initiated.

A company in administration is under the control of the appointed administrator who is given a short period of time (usually eight weeks) to set out a proposal for achieving the aim of the administration, or to decide that it is not reasonable that the company can be rescued. A creditors' meeting is called, at which the proposals are accepted or rejected. The administrator takes over management of the company and has the power to appoint and remove directors.

The process for appointment of an administrator varies, and may or may not involve a court order. A company, its directors or one or more creditors (payables) can apply to the court for the appointment of an administrator. The court will grant an administration order only if it is satisfied that the company is – or is likely to become insolvent, and that the administration process is likely to achieve its purpose of rescuing the company as a going concern. It is also possible for an administrator to be appointed without a court order, either by a floating chargeholder, or by the company or its directors. Administration usually lasts for 12 months, after which time the administrator automatically vacates office, though the period of administration can – in some cases – be extended subject to approval from creditors (payables). On the other hand, administration may not last for the full 12-month period, and may end early if the administration has been successful.

Liquidation
If the company cannot be saved, then liquidation or 'winding up' is likely to be initiated. The company will cease to trade, assets are sold, liabilities are paid (to the extent allowed by the proceeds from the sale of assets and by applying the rules for allocation of assets described below), and eventually the company will be dissolved. Once liquidation proceedings are under way share dealings must stop, and the directors lose their power to manage the company.

The procedures involved in placing a company into liquidation are complicated by the fact that there are different ways that the process is initiated – compulsory liquidation, members' voluntary liquidation, and creditors' voluntary liquidation.

Compulsory liquidation is usually initiated by one or more creditors, who apply to the court and must demonstrate that the company is unable to pay its debts. A creditor who is owed more than £750, and who has served the company with a written demand for payment that has not been settled, has grounds to apply to the court for compulsory liquidation. In less common circumstances, a member (shareholder) who is dissatisfied with the directors' management of the company may petition the court for the company to be wound up on the just and equitable ground. For this to be successful, the member had to demonstrate to the court that winding up is the only remedy available.

Voluntary liquidation can occur through two different routes – a member's voluntary liquidation, or a creditors' voluntary liquidation. The former is used where the company is solvent, and can only take place when the directors have made a declaration of solvency. Creditors have no involvement with this type of liquidation, as the declaration of solvency means that they will be paid in full and therefore have no risk exposure. Shareholders pass a resolution to wind up the company and appoint a liquidator, who is responsible for closing down the company.

In contrast, in a creditors' voluntary liquidation the creditors are heavily involved with proceedings, as in this case the company is not solvent, and therefore creditors face the risk that they will not be paid the full amount owing to them. The process is started by a shareholders' meeting where a resolution is passed to agree that the company should be wound up, but subsequently, the creditors' wishes over the appointment of the liquidator and the process of winding up will override the wishes of the shareholders.

Allocating company assets
An important issue arising on liquidation is the order of priority for allocating company assets. This is especially important for creditors and shareholders because, by definition, an insolvent company cannot pay everything that is owed. The amounts that will be paid on liquidation depend on matters such as whether debts are secured or unsecured, whether charges over assets are fixed

or floating in nature, whether shareholders own preference or equity shares, the costs suffered by the liquidator (which are generally paid first) and the amount of preferential creditors (including employees' salaries and other benefits in arrears). In most liquidations equity shareholders receive very little, and usually nothing, as they rank last in the order of priority in allocating company assets. The auditor of an insolvent or potentially insolvent company may be asked to advise on the allocation of company assets.

Advantages of administration
In many cases, it may be preferable to place a company into administration, rather than go through the process of liquidation. The obvious advantage is that if the administration is successful, the company will continue as a going concern, allowing shareholders to continue to hold their shares and, hopefully, eventually receive a return on that investment. In contrast, as mentioned above, shareholders usually receive nothing when a company is wound up. For creditors, the continued existence of the company may also prove beneficial, as its improved cash flows should allow debts to be repaid, and trading relationships can be maintained. Administration may also be beneficial to employees, as there will continue to be employment of some staff in the continued business (though, of course, the administrator may make some redundancies as part of the company's rescue plan). In contrast, in a compulsory liquidation the employees are automatically dismissed.

Conclusion
Auditors have a part to play in advising directors of companies that are in financial distress or, indeed, are insolvent. Candidates attempting Paper P7 (UK) or (IRL) must be prepared to identify the issues relating to insolvency in a given scenario and to provide appropriate explanations and recommendations. Auditing aspects of insolvency will not be examined at each sitting, but will feature fairly regularly in case study type questions. Studying from an up-to-date study text is essential.

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