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Proving Insolvency – A Financial Perspective

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Introduction

Even though it has a whole statute and a host of diverse rules to its name, the term 'insolvency' is not properly defined anywhere in the UK's company legislation. The Insolvency Act 1986 uses the phrase 'unable to pay its debts' – rather than the term insolvency – to describe that stage of a company's financial problems when the duties, powers and sanctions that can flow from insolvency law can be invoked. It has been left for the Court to interpret the precise meaning of this somewhat vague term. Historically, this has led to a lack of certainty, even among practitioners, as to when a company is – or is not – 'insolvent'.

As a forensic accountant specializing in insolvency litigation, I am often instructed to comment on the viability or solvency of a company. Frequently, when directors or insolvency practitioners examine a claim for recovery of a preference or a transaction at an undervalue, they presume insolvency simply because a company has subsequently entered into formal insolvency proceedings. Of course, the two things do not go hand-in-hand. In my experience, there is generally an insufficiently rigorous analysis of the question of if, and when, a company becomes insolvent.

Some recent cases have highlighted how the Courts will now pay more attention to the financial position and solvency of a company before committing it to a formal insolvency procedure or prior to reversing a pre-appointment transgression. There have also been some developments in how accountants are dealing with certain items in companies' accounts. Now is therefore an appropriate time to bring law and finance together in reviewing the concept of 'insolvency', at least as it applies in the UK.

The current legislation

Winding-up companies

The Insolvency Act 1986 states that a company may be wound-up by the Court if 'the company is unable to pay its debts'.[1]

The Act goes on to set out when the Court is entitled to conclude that a company is unable to pay its debts. It deals with two sorts of insolvency: the first being unable to pay debts as they fall due, otherwise termed 'cash flow insolvency',[2] and the second being situations when the company has a deficit of assets, known colloquially as 'balance sheet insolvency'.[3]

Section 123 of the Act defines 'inability to pay debts'. The most common situations are:

1. A statutory demand has gone unpaid for 3 weeks – s123(1)(a).
2. Execution or other process issued on a judgment debt has been returned unsatisfied, (or the equivalent Scotland or Northern Ireland processes) – s123(1)(b-d).

The Court can deem insolvency when either of the two above situations occurs. A proof of insolvency is not required.

This route does not prove that a company is unable to pay all of its debts, simply that it is unable or unwilling to pay the particular one demanded. Creditors without access to the debtors' records, therefore without the ability to prove a financial position to the satisfaction of the Court, will generally rely on these deemed presumptions of insolvency.[4]

Apart from exceptional cases, a creditor petitioning under s122(f) who satisfies one of the tests in s123 generally is granted the desired order. The process is not designed to wind-up companies where only one creditor is outstanding, however. The threat of an award of adverse costs, as well as general hurdles and

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1 Insolvency Act 1986, s122(1)(f).

2 *Ibid.* s123(1)(e).

3 *Ibid.*, s123(2).

4 See *Re Colt Telecom Group plc* [2002] EWHC 2815. This case highlights the particular problems faced by creditors who attempt to prove insolvency. The in this case the Judge refused to make a contested Administration Order based on the petitioning creditor's ' shaky, tentative, and speculative peering into the middle distance'.

procedures, prevent creditors from pursuing this option simply because of a dispute with a debtor.[5]

Failure to comply with a statutory demand is not the only way in which a company can be shown to be insolvent. Failure to pay an undisputed debt even though the creditor has not served a statutory demand for repayment,[6] or where a receiver has been appointed over the assets of the company, can both provide the basis for a winding-up order.

3. It has been proved to the satisfaction of the Court that the company is unable to pay its debts as they fall due – s123(1)(e). This amounts to proving insolvency on a cash flow basis.
4. It has been proved to the satisfaction of the Court that the value of the company's assets is less than the amount of its liabilities (including contingent and prospective liabilities) – s123(2). This amounts to proving insolvency on a balance sheet basis.

Unlike the first two situations that deem insolvency, these situations require proof of insolvency to be demonstrated on the balance of probabilities. Such proof can be provided to support a petition by a debtor for administration, or to be wound up. This is usually done as a last resort by management facing problems. This position can be proved on either a balance sheet or a cash flow basis, although quite often both will apply.

Another situation requiring a proof of insolvency occurs when an office holder seeks to overturn a pre-appointment transgression, or the Secretary of State examines the behaviour of a director. Here, the burden of proof of showing that the company was insolvent at a particular point in time falls on the applicant. This form of proof is generally subject to more stringent scrutiny by the Courts.

Other legislation

Preferences and transactions at an undervalue

Both preferences and transactions at an undervalue may be set aside if they took place at 'the relevant time'. This test has both time and financial components.[7] The time requirement dictates that the transaction must have occurred within either six months or two years – depending on whether or not it was with a connected party – of the onset of formal insolvency proceedings.

The financial test asks whether it took place at a time when the company was unable to pay its debts within the meaning of s123 or if the company became unable to do so in consequence of the transaction. When a transaction is at an undervalue with a connected party, there is a rebuttable presumption of insolvency. In other cases, the liquidator needs to show insolvency on the balance of probabilities.

Insolvency can be proved on either the balance sheet basis or the cash flow basis.

Directors' disqualification and wrongful trading

One of the most common allegations in disqualification proceedings against directors (under the Company Directors Disqualification Act 1986) is that they caused the company to continue to trade whilst insolvent to the detriment of creditors.

This has always presented a threat to directors of newer and smaller companies, which are often under capitalized in their early days, and therefore actually or potentially insolvent in balance sheet terms, even though they may be trading at a profit.

Although it is accepted that the applicable test for insolvency in an action of this nature is one or the other of the customary cash flow or balance sheet ones, a recent Court of Appeal case indicates that in disqualification proceedings the prosecutor may now need to establish both cash flow *and* balance sheet insolvency.[8]

Sir Martin Nourse provided the leading judgement in this case, stating:

> It is well established on the authorities that causing a company to trade whilst it is insolvent and secondly without a reasonable prospect of meeting creditors' claims is likely to constitute incompetence of sufficient seriousness to grant a disqualification order. But it is important to emphasize that it will usually be necessary for both elements of that test to be satisfied. In general it is not enough for the company to be insolvent and for the director to have known it. It must also be shown that he knew or ought to have known that there was no reasonable prospect of meeting creditors' claims .... It does not at all follow that because a company is insolvent especially when the insolvency appears on the face of the balance sheet and does not reside in inability to pay debts as they fall due, there is no reasonable prospect of meeting creditors' claims. The two things are quite different.

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5 In *Cornhill Insurance v Improvement Services Ltd* [1986] PCC 204, Harman J held that a company which was apparently solvent but refused to pay an undisputed debt could nevertheless be viewed as insolvent for the purposes of winding up.

6 *Taylor's Industrial Flooring v. M. and H. Plant Hire Limited* [1990] BCLC 216.

7 Insolvency Act 1986 s240.

8 *Secretary of State for Trade and Industry v Creegan & Another* [2002] 1 BCLC 99.

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In wrongful trading actions, a director is liable to contribute to the assets of the company if he: '… knew, or ought to have concluded, that there was no reasonable prospect that the company would avoid going into insolvent liquidation'.[9] In other words, if a company's assets are unavoidably insufficient for payment of all its liabilities, including costs of winding up. (It should be noted that the definition in this section also includes the costs of the winding up.) Thus, the applicable test here is balance sheet insolvency. The mere fact that a company is balance sheet insolvent is not, in itself, sufficient to amount to wrongful/continued trading, however. Further evidence is required to prove liability.

Liquidators often wait for the outcome of disqualification proceeding brought by the Department of Trade and Industry before launching wrongful trading actions. If the Court disqualifies a director on the grounds of unjustified continuation of trading, liquidators can feel more confident of a successful wrongful trading action. However, this confidence can often be misguided. The tests for trading to the detriment of creditors in disqualification proceedings, and wrongful trading under the Insolvency Act differ slightly. Statute does not impose a specific duty on directors to ensure that their companies do not trade at creditors' risk, or at a loss. On occasion, no finding of wrongful trading is made, even following a successful disqualification.

The cash flow test

The cash flow test is known overseas as equitable, or commercial, insolvency. This tests a company's ability to pay its debts as they fall due. It is of course possible for a company to be solvent on the balance sheet basis, but not on the cash-flow basis (it might have for example a large investment in valuable assets but no liquid resources to meet its immediate liabilities). If assets are unlikely to be sold, or if the sale of assets would indicate that the debtor's business was unsustainable, they are irrelevant for the purposes of the cash flow test.

Although the historic receipts and payments of a company are matters of fact (the cash either was, or was not, in a bank account), predicting future cash flows – particularly in businesses facing uncertainty and possible demise – is subjective and notoriously difficult.

Cash flow pressure

Aside from practical concerns, the test itself raises some interesting legal issues. For example, is being under cash flow pressure the same as being insolvent? Taking this even further, many highly respected businesses (respected by shareholders if not suppliers) stretch credit to the limit and are notoriously late payers. If a company pays its bills after 90 days instead of the agreed 30 days, can this be construed as not paying ones debts as they fall due, or is it just effective cash management?

Over the years, notably as defined by the Companies Act 1985, the test of cash flow insolvency has required that future or contingent debts should be considered. (This particular test was in fact an unsatisfactory mixture of cash flow and balance sheet measures). This stipulation was removed in the Insolvency Act 1986, when separate cash flow and balance sheet tests – as described above – were specified. The cash flow test seems in effect to have returned to what it was in the Companies Act 1862, as confirmed by the Courts in 1869, when the Judge in this case was of the opinion that unable to pay its debts meant 'debts absolutely due, that is to say debts for which a creditor may go at once to the company's office and demand payment'.[10]

In Australia, the position is that: 'A temporary lack of liquidity must be distinguished from an endemic shortage of working capital'.[11] An entity is solvent in the former case, and insolvent in the later. There continues to be debate on the meaning of 'temporary', but two to four weeks is a popular measure.

The Courts in the UK are also prepared to allow similar leeway. In the disqualification action following Mark Goldberg's unsuccessful purchase of Crystal Palace Football Club (CPFC), the prosecution claimed that in June 1998 the liabilities of CPFC exceeded its assets, and that the company at this time was unable to meet its liabilities as they fell due. Goldberg's company had just paid GBP22 million for an 85% stake in CPFC. At this time, CPFC had a credit balance on its bank account, and continued to do so until at least mid-August 1998. After Goldberg took control of the club, it did not pay its debts as they fell due; there was a delay paying its debts in June and July, but payments restarted in August 1998. The club subsequently did have more serious cash flow problems. In June 1999, accountants prepared a report stating the company – based on various assumptions – would be able to survive with an overdraft facility of GBP3 million. The club collapsed in the event. The Judge

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9 Insolvency Act 1986 s214.

10 *Re European Life Assurance Society* [1869] LR 9 Eq 122.

11 *Hymix Concrete Pty Ltd v Garrity* [1997] 13 ALR 321, 328.

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found that CPFC may well have been insolvent in January 1999, but he was not prepared to find that the directors knew, or ought to have known, this at the time, and certainly not in June 1998.[12]

Borrowed money

As often happens after the cash flow modelling exercise has taken place, it is found that the cash flow might stay within the overdraft limit if credit terms are stretched and/or money is borrowed. Is this simply replacing one liability with another, thereby not improving a company's liquidity? On the other hand, if a company has assets that can be mortgaged or realized to generate liquid funds, then does this that mean that it is not necessarily insolvent?

It was held in 1986 that a company that ultimately pays its debts with money borrowed from other sources is not necessarily unable to pay its debts.[13] This followed a 1978 case, which held that a company that had insufficient cash with which to meet all present accrued liabilities, but would likely to have been able to do so given a little time with which to realize assets, was not insolvent on the cash flow test.[14,15]

Assessing viability and cash-flow solvency

It is difficult to prove cash-flow insolvency without compiling a formal cash-flow forecast, looking at the situation as it was at the time. This is a document that considers receipts into and payments out of a company's bank account over the period of the forecast. It requires assumptions based on past performance, current conditions and future prospects. The sensible approach is to compile the model using various scenarios and assumptions. These typically include:

– no change from the existing position
– continuation of previous trends
– lower than previous trends
– higher than previous trends.

Directors require a good understanding of cash flow to allow them to fulfil their statutory responsibilities. When considering the cash-flow test, the Court assumes certain standards of knowledge, record keeping and behaviour by the directors. Not keeping records and not being able to prepare accounts will not absolve the director from wrongdoing. Professional advice is needed when a board lacks the necessary skills. Directors should continually review and revise forecasts in the light of actual results, particularly when they face a period of financial uncertainty. The Court will consider what decisions the directors should have made, if adequate and timely financial information had been available.

Indicators of financial problems

A series of cash-flow projections, based on sustainable assumptions and on a range of scenarios, is the gold standard for proving or disproving insolvency on the cash-flow basis. It is possible to gain some corroborative evidence from the way the business was operating. Companies facing cash-flow problems typically exhibit some or all of the following characteristics:

– deterioration in payment performance
– new mortgages and charges to secure further borrowings
– shareholders taking charges to secure their own existing lending to the company
– directors or auditors resigning as they try to distance themselves from a failing company
– a delay in filing accounts: perhaps the auditors are nervous about signing off, or there are going concern questions
– a revaluation reserve in the balance sheet: this can be largely a cosmetic exercise and an attempt to bolster balance sheet strength.

The balance sheet can also give some clues as to a company's liquidity. The following ratios are common indicators of the relative level of liquid assets on hand:

Current ratio: current assets / current liabilities. If less than one, this implies that the business does not have enough current assets to settle its immediate debts, and may need to borrow.

Quick ratio, or acid-test ratio: cash + debtors / current liabilities. Often considered a more reliable indicator of a company's ability to meet its short-term financial obligations. Because stock can sometimes be difficult or slow to realize, this ratio deducts stock from current assets before computing the ratio. Potential creditors like to use this ratio because it reveals a company's ability to settle their debts under the worst possible conditions. A ratio of greater than one is ideal, although many businesses operate with a ratio of 0.5 to 0.8. Ratios any lower than this may indicate problems.

(One word of warning on the ratios. It pays to examine carefully the details of the debtors to ensure

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12 *Secretary of State for Trade and Industry v Goldberg and McAvoy* [2003] EWHC 2843 (Ch).

13 *Re A Company* [1986] BCLC 261.

14 *Re Capital Annuities* [1978] 3 All ER 704.

15 In the Australian case of *Rees v Bank of New South Wales* [1964] 111 CLR 210, solvency was not determined solely to be cash on hand but included other factors such as the ability to raise finance through the selling or mortgaging of assets.

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that the calculation does not rely on any substantial element of non-trade debtors or sundry debtors, which are often much less easily realized than their categorization might imply.)

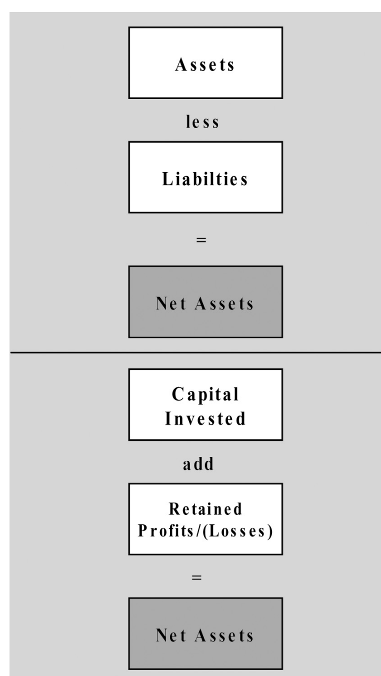
Gearing: Long-term debt / total net assets. The gearing ratio measures the proportion of the company's total capital that is borrowed. The higher the gearing ratio, the bigger the proportion of the company's money that is borrowed and therefore the bigger the risk.

The balance sheet test

This test – known in the US as 'legal' insolvency – is based on the assets concept. A company is insolvent if its assets are less than the sum of its liabilities, including prospective and contingent liabilities. The fact that a company can pay its way is irrelevant.

The balance sheet is a fundamental accounting document. It is divided into two parts: the top part sets out the wealth of the company (its net assets, or if negative, net liabilities) and their components. This is numerically equal to the bottom half, which is the owner's equity, in the form of capital brought into the company, and accumulated profits or losses.

Set out diagrammatically:



There are several areas relevant to solvency where care needs to be taken.

Window dressing

The balance sheet is a snapshot of a company's asset and liability position at a particular point in time: the balance sheet date. The position one day before this date, or one day after this date, might be vastly different. This can lead to the phenomenon of 'window-dressing'. This is where transactions are entered into solely for the purpose of improving a company's financial appearance at the balance sheet date.

As an example, one popular method is to deliberately reduce stock levels at the balance sheet date, and build them up immediately afterwards. Although the net assets are unchanged, the balance sheet will show that current assets will be in the form of cash, rather than stock, and trade creditors will be lower. This will distort most conventional balance sheet ratio analyses: showing the company as having a more comfortable liquidity position and higher turnover of stock than it normally enjoys. Another way is for sales to be made to a related party in the few days before the year end, and the stock bought back in the first days of the new financial year. The result of this is to increase sales and debtors.

In accounting terms, the transaction which occurs immediately after the balance sheet date to reverse the window dressing is known as a post-balance sheet event. Such an event can be classed as either adjusting or non-adjusting.

If the transaction affects both the balance sheet and the profit and loss account it is likely that accounting rules class it as an adjusting event. In this case the accounts should show the 'real' position – having stripped out the effects of the window dressing. This would be relevant in the second example above.

Typically, non-adjusting events involve the balance sheet only – as in the first of the examples here. In this case, if it is material, the nature of such a transaction and its financial effect should be disclosed in the notes to the accounts.[16]

Going concern versus break up

Most financial statements are prepared on the basis that the entity will continue in operational existence for the foreseeable future (using what is termed the 'going concern' assumption).[17] The accounts for the purposes of solvency assessment should similarly be drawn up on this basis.

The going concern assumption implies that there is no intention or necessity to liquidate or curtail

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16 Statement of Standard Accounting Practice 17.

17 An entity should prepare its financial statements on the going concern basis, unless (a) the entity is being liquidated or has ceased trading, or (b) the directors have no realistic alternative but to liquidate the entity or to cease trading.

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significantly the scale of operation of the entity. Assets therefore are recorded on the basis that the entity will be able to recover, through use or realization, the recorded amounts in the normal course of business and liabilities are recorded on the basis that they will be discharged in the normal course of business. As would be the case in break-up accounts, assets would not usually be written down to 'fire-sale' amounts, and liabilities would not normally include liabilities for redundancies, other closure costs or breach of contract.

If looking at a pre-appointment transgression, the financial position should be assessed from the point of view of a board facing a problem, with the information available to the directors as at the time. It should not be assessed from the perspective of an insolvency practitioner looking at a case with the benefit of hindsight.[18]

Defining assets and liabilities

What assets and liabilities should be included in the balance sheet? Indeed what is an asset or a liability? Accountants tend to think about assets in terms of 'rights or other access to future economic benefits controlled by an entity as a result of past transactions or events'. Liabilities are 'obligations to transfer economic benefits' – usually the transfer of cash.[19] Even with these wide definitions, financial derivatives and products continue to blur the line between liabilities and equity.[20] Identifying assets and liabilities, and measuring them properly, requires some degree of judgement, aided by accountancy skills if necessary.

Contingent and prospective liabilities

The Insolvency Act specifically states that the balance sheet should include 'prospective and contingent' liabilities. What does that mean? Should a company have to take into account future amounts payable amount under, for example, leases with perhaps years still to run? To do so would render most companies insolvent. My view, and the feeling of many practitioners, is that this is not necessary, provided that the company has a reasonable expectation of being able to make future profits from the assets giving rise to these future costs.

Accounting standards actually discourage the recognition of provisions and contingencies as liabilities on the balance sheet. They should be reflected only when they relate to an obligation which has already arisen at the balance sheet date, which is probably going to result in a future payment, and a reliable estimate can be can be made of the amount of this prospective liability. Mere possible future obligations, or those that can't be properly measured, are merely highlighted in the notes to the accounts. Remote contingencies are ignored.

How should company pension scheme deficits be treated? Many companies took pension holidays during the 1990s boom, using the rising price of investments to justify halting their contributions or even taking money out of their funds. Now it is estimated that in the UK alone, companies owe GBP160 billion to pension funds. In November 2000 the UK adopted a new pension accounting standard.[21] This is not yet fully implemented, but is being phased in gradually. The effect is to require companies to fully provide for the amounts it owes to its pension scheme. (The previous accounting treatment allowed this to be spread over the working life of scheme members: new rules require this cost to be recognized immediately). When looking at company accounts it is therefore necessary to seek out the disclosure note relating to pension liabilities (if any) and consider adding this into long-term liabilities.

On the assets side, a contingent asset should be disclosed if an inflow of economic benefit is probable. This mirrors the approach of the Court, which has held that only those assets that are assets of the company at the relevant time should be included. Prospective assets (such as potential cash injections) ought not to be considered.

One of the possible abuses that can thwart the requirement to include 'prospective and contingent' liabilities is the creation of off-balance sheet liabilities. In recent years, the capital markets have developed into ever more complex areas, and banks have competed with each other to develop more sophisticated and innovative methods of financing. The pace of this innovation has often outstripped the development of rules for financial reporting. Off balance sheet finance is one particular area where the accounting standard-setters are only now catching up.

The most usual approach to quantifying liabilities which will arise in the future is to discount them to current present values, by a discounting process that takes into account the time value of money). Contingencies – which may or may not occur – are

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18 *Re Gower Enterprises Ltd.* [1995] BCC 293.

19 Accounting Standards Board Statement of Principles for Financial Reporting.

20 See for example Financial Accounting Standards Board (a US body) Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity.*

21 Financial Reporting Standard 17.

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discounted to present value, taking into account probability of contingency will occur, as well as the time value of money.[22]

The role of accounting standards

Usually, the date at which solvency needs to be assessed does not happen to coincide conveniently with a balance sheet date, or a date to which comprehensive management information has been prepared. There are two difficulties: how do we assess solvency at a date for which there were no accounts; and how do we deal with management accounts and unaudited information.

The process known as 'retrojection' allows a Court to assume insolvency at an intermediate date. If there are no accounts for the date of a particular questionable transaction, then if it can be shown that the company was insolvent on one date, and insolvent on the last relevant date, and in the absence of any substantial or relevant changes in assets and liabilities between these dates, it is reasonable to assume that it was insolvent at all intermediate times. This approach has considerable justification for short periods, but it can be problematic for periods of more than a few months before a date of proven insolvency.

It is necessary that the accounts to be used are properly prepared and need to show a true and fair picture of the financial position. That is not to say they need to have been audited, but they need to comply with Generally Accepted Accounting Principles.[23]

It should be noted that true and fair is a subjective matter, and there may be several ways of drawing up differing accounts of the same financial position – all of them 'true and fair'.

Valuing assets

Even though the balance sheet is prepared on a going concern basis, how should assets be valued? This is particularly relevant when looking at management accounts: often provisions and adjustments are not made in management accounts, but would be to allow them to show a true and fair picture. Although this might be used to 'prove' insolvency, it does not necessarily follow that the directors would have been aware of these adjustments.

Again, accounting standards provide some guidance:

- A tangible fixed asset should initially be measured at its cost, then written down to its recoverable amount if necessary.[24] It is permissible to adopt a policy of revaluation of fixed assets. In this case its carrying amount should be its market value (or the best estimate thereof) as at the balance sheet date. If this approach is adopted, then a consistent and regular policy of revaluations should be applied.
- Stock is valued at the lower of cost and net realizable value. (So if it cost GBP10,000 but could only be sold for GBP8,000 then it should be reflected in the balance sheet at its net realizable value of GBP8,000). A provision may therefore be needed for obsolesence of stock (thus reducing net assets and profit in the year)
- Investment properties should be included in the balance sheet at their open market value .

Accounts are prepared on a prudent basis, and it is not unusual for a company to own assets which are either fully depreciated (hence have only minimal value in the accounts) or kept out of the balance sheet altogether. The valuation of fixed assets not included in the balance sheet was also argued in the Goldberg and McAvoy disqualification case. The defendants contended that the main reason that assets were less than liabilities and that the balance sheet was insolvent on its face was that the it did not include the value of the playing squad, and undervalued its interest in the football ground, Selhurst Park.[12]

Goodwill

To accountants, goodwill is the difference between the cost of an acquired entity and the fair values of that entity's identifiable assets and liabilities. Positive goodwill arises when the acquisition cost exceeds the aggregate fair value of the net assets purchased. Purchased goodwill, as well as intangible assets such as brands that have been acquired from third parties should be capitalized as assets. These assets must be

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22 This approach to quantifying off balance sheet liabilities is endorsed by the Basle Committee on Banking Supervision. The 1998 Capital Accord encourages banks and other finance houses to convert off-balance sheet to credit risk equivalents by multiplying the notional principal amounts by a credit conversion factor. The resulting amounts are then weighted according to the nature of the counterparty. For example, standby letters of credit serving as financial guarantees for loans carry a 100% credit risk conversion, while revolving underwriting facilities (which are less likely be called) require 50%. The credit risk of derivatives is assessed by calculating the current replacement cost, plus an 'add-on' to account for potential exposure. This varies depending on the volatility of the underlying asset and residual maturity of the contract. See <http://riskinstitute.ch/00007082.htm>.

23 There is authority for the view that a company will not normally meet the 'true and fair view' requirement unless it observes current accounting standards . This is contained in a 1993 Opinion of Mary Arden QC (now Mrs Justice Arden) and reproduced in the introduction to the annual volume *Accounting Standards*, published by The Institute of Chartered Accountants in England and Wales.

24 This was dealt with extensively in the *Colt Telecom* case, when Jacobs J considered the application of FRS11 to asset values.

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depreciated and subject to the usual rules on provisioning if their recoverability becomes uncertain.

Internally generated goodwill should not be capitalized and internally developed intangible assets should be capitalized only where they have a readily ascertainable market value.

Can internally generated goodwill be taken into account for the purposes of assessing balance sheet solvency? In my opinion, the argument does have merits, but only if the goodwill is saleable.

The argument that a balance sheet should reflect non-purchased goodwill, which would have made a company solvent has been considered before the Court. The approach was not rejected, but it was found that the case turned on its facts, and in this case the loss-making business of the company was unlikely to have any goodwill attaching to it, particularly as attempts to dispose of it had been ongoing for some time.[25]

Proving insolvency

As stated earlier, the ability of creditors to ask the Court to deem insolvency makes their position easier. The most challenging task is for liquidators or prosecutors looking at situations that occurred well before they became involved. Their proof therefore relies on:

– the authenticity of books and records
– hearsay evidence from creditors and directors
– expert opinion.

To avoid challenges, the liquidator should ensure that a list is maintained of what company records were collected; and the location and circumstances surrounding such collection. They should be tied in to the company's business system.

Although the question of whether a company is or is not insolvent is one for the Court, not for an expert, expert evidence is often used to help the Court understand questions of accounting practice, and a company's financial position at the relevant times. This is frequently the domain of an accountant specialist in this area rather than the generalist insolvency practitioner.[26]

In summary, the question of 'insolvency' is an evolving area of law and accountancy, which will keep practitioners on their toes for years to come. Contrary to the views of some, it is not an area where a few broad generalizations can sway the Court. It is instead one where critical analysis and looking behind the published financial accounts – to consider the true financial position – can really pay dividends.

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25 *Katz v McNally* CHANF96/1162/CMS4 (1998).

26 See Jacob J's comments in *Colt Telecom* and his criticism of the evidence of the proposed administrator.

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