Societies facing up to financial strife

September 2020

Introduction: solvency and liquidity

This guidance note is written for societies registered under the Co-operative & Community Benefit Societies Act 2014, and particularly those societies whose members have bought shares in them. It has been written in line with the new Corporate Insolvency and Governance Act 2020 and will be updated accordingly as circumstances change.

The Insolvency Act 1986 uses the following tests to determine whether a society is solvent or not:

- the **"cash flow test"** (ability to pay debts as they fall due) and;
- the **"balance sheet test"** (value of a society's assets is less than its liabilities, taking into account its contingent and prospective liabilities).

A society can be deemed legally insolvent, and be subject to a winding up petition and order accordingly if it fails the "cash flow test" even if it has a positive balance sheet.

For clarity, this note is designed to support societies understand the differing circumstances leading to insolvency (in both senses) and actions available to them. This will be discussed from a **management accounting perspective**, using the following definitions of **solvency** and **liquidity**.

Solvency means the society's assets exceed its liabilities. Put another way, it means that the society could in theory pay everyone it owes money to, including long-term lenders, and still have something left over. If there is a risk that the society could not pay all it owes, then the society is insolvent. In such circumstances the directors have a duty of care to the society's creditors and must wind-up the business unless there are reasonable grounds for thinking that it can return to solvency in the short to medium term. It is the directors' duty to make sure the society is a going concern, or if it is not, that they have a credible plan for returning to solvency.

Liquidity means having the cash to pay bills as they fall due. It is an immediate and short-term matter. Can we pay employees, suppliers and other creditors? Will the bank honour our payments? Will those who owe us money pay it on time? To answer these questions, we need to look at the society's cash flow, the timing and amount of money coming in and going out of the business.

Solvency and liquidity may sound similar and they are connected, but not always in a straightforward way.

For instance, a society might have a strong balance sheet but have problems with cash flow. This might be the case for a society that has lots of its money tied up in fixed assets, like property or equipment, but is low on cash to pay its bills. In such circumstances, it is reasonable for a society to ask members for new share capital if its Rules permit this, or to borrow money, as long as it is confident that it will not incur losses that will threaten its balance sheet solvency before it can return to profitability and solvency. In such circumstances, increasing share capital will improve solvency while loans will undermine it.

More problematically, a society might be liquid but approaching balance sheet insolvency. Even though it has the cash to pay bills, the society is making a loss and building up liabilities it will not be able to meet in the future. These might result from strategies to improve short-term liquidity, without sufficient regard to future profitability, such as encouraging customers to prepay for goods or services, or deferring payment of rent, rates and taxes. The society might also face contingent liabilities such as redundancy costs or bad debts caused by the insolvency of its customers. Monitoring and forecasting future profits and losses is vital in anticipating the threat of insolvency.

Finally, there is a danger that the value of fixed assets on the balance sheet have been impaired by the current crisis, especially commercial property assets. In some cases, where the income generated by fixed assets is unaffected by the crisis, then the impairment of value is less likely. There are provisions in accounting standards for the revaluation of fixed assets which may need to be considered when the annual accounts are being prepared.

The worst-case scenario is that a society is both struggling with its cash flow and its balance sheet. It has run out of cash and has no reasonable hope that it can one day become a profitable business. In such circumstances, the directors' balance of care shifts to doing their best by their creditors. They may have an immediate duty to wind-up the business, and not incur any further liabilities. But if a society has been monitoring its solvency, it can explore various other options before it is too late. These options are explained later in this guidance.

Directors have a responsibility to ensure the society is solvent and can meet its liabilities.

Wrongful trading, knowingly entering into transactions when the society is insolvent, can result in directors being disqualified and made personally liable for creditor debts. However, new legislation has been brought in to give Directors some leeway in the current circumstances.

The Corporate Insolvency and Governance Act 2020 (CIGA 2020) gives societies a grace period from 1st March – 30th September 2020, restricting winding up petitions and orders if coronavirus has had a legitimate financial impact on the society.

The CIGA 2020 also brought in a 'suspension of wrongful trading liabilities' which assumes that the Directors were not responsible for any worsening of the financial position of the society for the same period. Whether this grace period will be extended past the 30th September 2020 is still to be confirmed.

First steps

Here are the first steps that should be taken to address the financial aspects of a range of crises or difficulties that may affect a society:

- Make sure your bookkeeping is up to date, and that you have completed a bank reconciliation, to confirm that your accounts tally with your bank balance. Ideally, your management accounts will include information on your cash position and cash flow going forward, plus a profit and loss statement for the year to date and a current balance sheet.

- Establish a rolling 13-week worst-case cashflow forecast keyed into the actual cash in bank for a specific date: capture all the underlying assumptions, review them frequently, at least monthly, and keep all directors informed: Boards should approve this cash flow document (often for context compared to pre-crisis/difficulty budgets).
- Be aware of who your creditors are, especially those who may be in a position to initiate insolvency proceedings against the society.
- Review the current and future balance sheet position (13 week intervals for next 12 to 18 months) to determine whether the society is, and will remain, solvent and the society is a "going concern". If accumulated losses are growing, don't panic, seek advice and take the action set out in this document.
- Where appropriate, contact your members to inform them of your current financial position and risks to the longer-term survival of the society. Describe what actions you are taking to address the financial position and your timetable for these actions.
- Let members know what the impact might be on the society's ability to pay share interest and allow share withdrawals.

If there is any threat that a society may be approaching insolvency, and its members hold share capital in it, a society must suspend share withdrawals and notify its members of this action.

This should include a notice to members and ex-members who have recently withdrawn share capital that they remain liable for the debts of the society, up to the value of their shares, for up to twelve months after they have withdrawn their capital.

Two quick indicators

Here are two quick indicators and rules of thumb you can use to assess your society's liquidity and solvency.

Liquidity indicator: cash cover
This is a simple way of assessing liquidity by calculating how many weeks of cash cover your society has.

First, calculate your average weekly expenditure:

$$\frac{Total\ planned\ expenditure\ for\ next\ 13\ weeks}{13} = average\ weekly\ expenditure$$

Then calculate how many weeks of cash cover you have based on your weekly expenditure:

$$\frac{current\ available\ cash\ (inc.\ overdraft\ facility)}{average\ weekly\ expenditure} = number\ of\ weeks\ cash\ cover$$

If you have:

- 13+ weeks cash cover: The society is reasonably liquid in the short term
- 8-12 weeks cash cover: Start planning now how to improve cash flow
- 4-8 weeks cash cover: Stop planning and take action to obtain additional cash
- Less than 4 weeks cash cover: Time for emergency measures to increase cash availability

Balance sheet solvency indicator: simple solvency ratio
This is a simple and coarse measure of solvency, that ignores a number of other factors that may be affecting the society's solvency, but will provide a quick indication of whether a problem with solvency is looming. For a given point in time take the share capital held by the society and the value of its reserves (accumulated profits or losses).

Then calculate your simple solvency ratio:

$$\frac{Reserves\ (accumulated\ profits\ or\ losses)}{share\ capital} = simple\ solvency\ ratio$$

If you have a:

- Positive ratio above 1.0: very solvent, OK to borrow (more), pay share interest, and allow withdrawals
- Positive ratio between 0.5 and 1.0: solvent and no immediate threat of insolvency
- Positive ratio between 0 and 0.5: solvent but need to calculate future profits/losses and potential threat of insolvency
- Negative ratio between 0 and -0.5: Time to plan and take emergency measures to deal with the threat of insolvency
- Negative ratio greater than -0.5: Time to start facing up to insolvency or dissolution

Responding to a crisis

Responses will fall into three broad types of action:

1. **Maintaining liquidity**: This involves managing your society's cashflow, anticipating how your cash requirements will change over coming months, accessing support where it is available, negotiating with debtors and creditors, and maybe raising additional working capital.

2. **Improving solvency**: Given the difficulties of improving profitability in a crisis, other ways of improving solvency is to raise additional risk capital, explore options for amalgamation or transfer, or develop new and profitable business opportunities.

3. **Facing up to insolvency**: If having reviewed the financial position of your society you have come to the conclusion that the threat to your going concern status is real and imminent, then you need to act now to have some control over the process of insolvency, and to explore rapidly ways of saving the business and protecting creditors and shareholders.

1. Maintaining Liquidity

If you are confident that there is no imminent threat of insolvency, then your attention can turn to maintaining the liquidity of your society. This means addressing the following matters:

Put employees and volunteers first: Your first concern should be your employees and volunteers. Can they continue to work from home, what support do they need to do this? If they cannot work from home, and your business provides an *essential service*, or is undergoing *business repurposing* so that it can continue to trade, have the employees agreed to these actions and had a say in their design. The same applies to any volunteers. If it is not possible or financially viable for your society to continue operations then you need to decide whether to furlough employees (for the duration of the Job Retention Scheme)or make them redundant. Other options should be discussed with employees, such as reducing pay and working hours. Redundancy may be the only option if the society is at risk of insolvency, with the costs of redundancy further compounding that risk.

Access government financial support: The government has a range of initiatives to help businesses with their cash flow. Full details of the initiatives, amongst others, can be found on the Co-operatives UK website and UK Government website.

Involve your members: Let your members know how the crisis is affecting the society and your plans for addressing these problems. Suggest how members can help the society, as customers, volunteers and investors. Give members a more detailed picture of how the crisis is likely to affect the society's longer-term ability to pay share interest and fund share withdrawals. Consider the possibility of launching a 'Recovery Share Offer' to raise additional working capital. Further guidance on Recovery Share Offers is available here.

Negotiate with customers, funders and debtors: It may be possible to negotiate with your customers, funders and other people who purchase goods or services from you, or provide you with revenue grants or donations, to help you with your cash flow. They can do this by paying you in advance, making prepayments, and building up credit with you.

Negotiate with suppliers, landlords and other creditors: Talk to your suppliers about the contracts you have with them to see if it is possible to come to a mutually beneficial arrangement that might involve the deferral of delivery and/or payment. The government has acted to prevent landlords evicting tenants during the Covid-19 crisis, and landlords might be prepared to accept deferrals, reductions or even holidays from rent payments. Other creditors, including lenders, might be prepared to help you with cash flow by deferring capital and/or interest payments.

If you still face cash flow problems, obtain a loan: Borrowing to address cash flow problems is the option of last resort, and should only be turned to if you are confident that it will not lead to insolvency in the longer term. To understand the cost of borrowing and determine how borrowing will affect the profitability of the society, you can use the **interest coverage ratio**, calculated based on a defined period and ideally revisited on a regular basis.

$$\frac{Earnings\ before\ interest\ and\ taxes\ (EBIT)}{interest\ payable} = interest\ coverage\ ratio$$

If the interest coverage ratio is less than 1.5, the more the society will be burdened taking on debt.

Ensure you consider the costs and cash-flow implications over the full term of the loan. If you have existing borrowing, you will probably need to obtain your lenders permission before taking on any new loans. The government has launched loan schemes to support businesses, you can find out more detail on the Co-operatives UK website and UK Government website.

2. Improving solvency

Determining whether a society is solvent, or not, is more of a balanced assessment than simple calculation, especially in a time of great uncertainty about the prospects of the economy. For instance, it is impossible to calculate the realisable value of property, at a time when property transactions have been suspended. Other assets, such as stock, work-in-progress and debtors, may or may not be realisable. Stock may deteriorate, work-in-progress may be cancelled, debtors may go bust. The same applies to liabilities, where creditors may be prepared to settle for less, when faced with the prospect of losing all.

Raising additional share capital is a great way of improving the solvency of a society and staving off the threat of having to wind-up operations and ceasing to exist. New capital may be required to cover temporary losses, repurpose business models, prepare for the costs of resumption of normal trading, or develop new services. Members may be prepared to invest additional share capital to protect the society from insolvency and losing some or all of the money they have already invested. Asking existing members to increase their share capital when the society is under threat is a major call on members' loyalty and commitment. That is why we are proposing new guidance for Recovery Share Offers.

Other alternatives include the option of amalgamation with, or the transfer of engagements to, another legal entity, preferably another organisation that is highly solvent. This could be another society in the same sector of activity, looking to consolidate its operations and reach a more sustainable scale. Or it might be a much larger, older and more established society looking for new market opportunities and diversification. Amalgamations and transfers of engagements require special resolution to be passed at a general meeting. Any amalgamation or transfer of engagements must respect the prescribed or charitable asset lock rules of the societies involved, if such rules exist.

There are other ways that members can contribute to the capital of the society and improve its solvency. A call for gifts and donations may be as successful as an emergency share offer and need not be restricted in the same way as a share offer. Charitable community benefit societies could ask members to gift some of their share capital to the society (whilst retaining the minimum share capital required for membership), so that the society can claim gift aid from HMRC.

3. Facing up to insolvency

If your society is heading towards insolvency, but there is a realistic prospect that the society could be rescued, and/or jobs saved, then it is far better to act straightaway, rather than losing control to an expensive insolvency practitioner, once insolvency proceedings are initiated. It may be possible for the directors to negotiate a voluntary arrangement with the main creditors or seek the transfer of undertakings to another solvent society.

Following a recent change in the law (the Corporate Insolvency and Governance Act 2020), directors of 'pre-insolvent' and insolvent societies can also apply to the court to enter into a new 'moratorium period'. During the moratorium period, directors remain in control of the society and the society will be protected from legal action by creditors. The intention is that this gives a struggling society some formal breathing space to pursue a rescue plan. The initial moratorium period is 20 days and this can be extended by a further 20 days with a further application to the court. Further extensions beyond this require creditor approval. The court will appoint a 'moratorium monitor' who can end a moratorium or block extensions if they believe a turnaround is unlikely. The law requires that this monitor has regard for the rules of the society and its obligations under the Co-operative and Community Benefit Societies Act (which includes commitments to co-operative or community benefit purpose). Societies should note that the law prohibits share withdrawals during the moratorium period.

The law has also changed to provide a new 'restructuring procedure', for solvent societies in distress and insolvent societies to reach new arrangements and compromises with creditors. Under this procedure a court can sanction a plan that binds creditors to a restructuring plan, if it is fair and equitable and in the interests of creditors. Creditors and society shareholders vote on the plan, but the court can impose it on dissenting creditors and shareholders provided that the necessary conditions are met. This is called 'cross class cram down'. A plan can only be enforced once the Financial Conduct Authority confirms that the elements of the plan are not contrary to the rules of the society or the Co-operative and Community Benefit Societies Act.

But if you think the society may be insolvent, with no realistic prospect of recovery, then you must take immediate action to protect the directors from the claim of creditors that they were acting *ultra vires* (beyond one's legal power or authority), and may be personally liable for the debts of the society. At the point of insolvency, when the accumulated losses are equal to, or greater than, the equity invested in the society, then the society must take steps to call in an insolvency practitioner who will help determine which of the following insolvency options are open to the society. Insolvency means that members lose all of their share capital.

Since 2014, societies are subject to the same insolvency laws as companies and are treated in the same way, with a few specific exceptions. These exceptions include a requirement that the FCA Mutuals Registrar must be notified of any application for an administration order. The FCA has the power itself to apply to court for administration order. Some of the following options might not apply to societies that are registered housing providers, or to societies carrying a fixed or floating charge that was taken out before August 2014. The process of administration is also slightly different for societies, as outlined, in the final part of this document.

There are six options open to an insolvent society:

- **Moratorium**: The new moratorium period is open to insolvent as well as solvent societies. This gives insolvent societies 20 days of protection from creditors with directors in control to put a rescue plan together (see section above for more details).

- **Administration**: This is where the administrator tries to rescue the society as a going concern or achieve a better outcome for creditors than winding-up the society. The society might continue trading while these options are being pursued.

- **Company voluntary arrangement (CVA) or scheme of arrangement**: This requires the voluntary agreement between the society and its creditors to come to an arrangement for the discharge of debts that allows the society to continue as a going concern. The majority of creditors must agree to this arrangement for it to be binding on all creditors, but it cannot be imposed on secured creditors.

- **Restructuring procedure:** the new restructuring procedure is open to insolvent as well as solvent societies (see above for more details)

- **Receivership**: A secured creditor with a fixed charge over an asset may appoint a receiver to sell the asset in question to discharge the debt. In some limited circumstances this can also be applied to debenture holders.

- **Liquidation**: The society ceases trading and the liquidator sells the society's assets and distributes the funds to creditors.

In insolvency, all of these options involve the appointment of a qualified insolvency practitioner to act as the monitor, administrator, receiver or liquidator, and who can deduct their fees and costs, ahead of all other creditors, from the proceeds of the insolvency action. These charges can be very high.

When an insolvency practitioner is appointed as administrator, receiver or liquidator, they take over control from the society's directors and although they may choose to continue to draw on the directors' expertise they are not obliged to do so. Directors will have no rights to access member registers, or to communicate with members without the consent of the insolvency practitioner, so directors may want to establish parallel communication methods with members before appointing an Insolvency practitioner.

Administration in a society

A society can voluntarily decide to enter administration. Alternatively, it may result from a court order, or an out-of-court notice, raised by a secured creditor with a fixed or floating charge against the assets of the society. The FCA Mutuals Registrar can also initiate such actions. An administrator (a qualified insolvency practitioner) is appointed who is tasked with achieving one of three objectives, in descending order of priority:

- Rescue the society as a going concern
- Achieve best outcome for creditors
- Sell property and assets to distribute to secured creditors
- Or a combination of the above objectives

The objective is fixed in the court order (or out-of-court notice) and it is the job of the administrator to develop a proposal to achieve this objective, or to explain why the objective cannot be achieved. The proposal must be sent to every creditor and member, along with an invite to a creditors or members meeting. Members meetings have parity with creditors meetings in terms of approving, varying or rejecting the administrator's proposal.

The administrator cannot propose anything that is contrary to the requirements of the Co-operative and Community Benefit Societies Act (CCBSA) 2014. Any proposal involving the amendment of the society's rules must be approved by the FCA. Any proposal that involves the transfer of the society's engagements, its amalgamation with another society or company, or conversion into a company must be approved by members using the procedures set out in Sections 109-114 of CCBSA 2014.

Company voluntary arrangement (CVA) or scheme of arrangement

In some cases, a CVA or scheme of arrangement may be proposed by an appointed insolvency practitioner if they think the consent of creditors can be obtained to an arrangement for the discharge of debts that allows the society to continue as a going concern. Such arrangements cannot be imposed on secured creditors, but they may agree to it if they think it is in their best interests. Then if the majority of unsecured creditors agree to an arrangement, it can be imposed on other unsecured creditors, and the society can continue as a going concern. It may be possible to make similar voluntary arrangements with the major unsecured creditors without incurring the costs of appointing an insolvency practitioner and the other costs associated with a CVA, which is why it is important to consider such options before becoming insolvent.

Receivership and liquidation

Receivership and liquidation are procedures carried out by a qualified insolvency practitioner who acts in the interests of creditors, be they secured (receivership) or unsecured (liquidation). It is highly unlikely that member shareholders will receive even a tiny fraction of their share capital, as they are the last in the line of creditors. But until the value of society's assets are actually realised, it is impossible to be certain what the outcome will be. An insolvency practitioner can pursue members who have withdrawn some or all of their share capital within twelve months of the insolvency action for the return of that capital to distribute to other creditors.

Other maintenance matters

Regular board meetings – regular board meetings are vital during this period and there is plenty advice on using online platforms if required to ensure regular communication.

AGMs – The Co-operatives UK governance webpages have lots of advice on managing general meetings and using online platforms where required to ensure effective engagement and representation of all members at this crucial time.

Annual accounts and returns – the FCA has confirmed that societies can postpone their submission of their annual accounts and returns by up to three months, further advice on the Co-operatives UK governance webpages.

Good practice with employees – looking after employees at a time of crisis is crucial, for more support see the Co-operatives UK HR webpages.