The Decision to Enter Voluntary Administration: Timely Strategy or Last Resort?

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Abstract

One of the options available to directors of financially distressed companies is to place their company into voluntary administration (VA). The decision to enter VA should enhance corporate governance because it allows for informed decision-making about a company’s future, and ensures that administration of a company’s affairs proceeds in an orderly manner. Once in VA, a company has a short ‘breathing space’ during which it can develop a strategy to address its insolvency. The strategic options available will be significantly affected by past performance and current financial position. If the company’s position has deteriorated significantly, the VA process will merely delay an inevitable liquidation. Therefore, a timely decision about entering VA is critical to the effectiveness of the procedure. This paper attempts to shed some light on the timeliness of the decision to enter VA. It presents an exploratory empirical examination of the change in financial characteristics for a sample of listed public companies over the critical time immediately prior to VA. The analysis focuses on how the changes that are observed affect prospects for reorganisation. The results suggest that the sample companies’ prospects for reorganisation were significantly diminished in the time prior to VA, and that directors should have taken more timely action.

Key Words: Insolvency, Voluntary Administration, Decision-making, Financial Characteristics.

1. Introduction

When a company experiences financial distress, continued sound governance is critical given the wide range of stakeholders that may be affected by poor decision-making. If a firm is financially distressed to the point where it becomes insolvent, a timely and considered response by managers may serve to limit the extent of harm resulting from failure. One of the options available to directors when their company is faced with insolvency is to place the company into voluntary administration (VA) by appointing an administrator under Part 5.3A of the Corporations Act 2001. The primary purpose of VA is to provide a flexible and relatively inexpensive procedure in which a company can attempt to formulate an arrangement with its creditors. The objectives of administration are twofold: to save the business conducted by the company or, to wind up the company’s business affairs in an orderly manner so as to provide a better return to creditors than would have resulted from an immediate liquidation.¹

Placing a company in VA at this critical time should enhance governance. Importantly, the VA process allows for informed decision-making about the company’s future. Mumford noted that information asymmetry can make it difficult for outsiders to tell when financial distress threatens a company, which may lead to opportunistic behaviour by directors.² Martel also commented on the effect of information asymmetry on the reorganisation decision, noting “bankruptcy procedures are characterised by incomplete information…this divergence of information can result in a sub-optimal solution to the debtor’s financial problems.”³ An advantage of the VA process is that it reduces the possibility of opportunism on the part of the company by ensuring that information is available that enables an accurate and realistic assessment of the company’s current position and future prospects. This promotes informed decision-making regarding the fate of the company. In addition, the VA process is designed such that any action taken to resolve the company’s situation will be conducted in an orderly manner. Therefore, even when a VA concludes with liquidation, the process should help to preserve the value of the company’s assets and improve the amount available for distribution to creditors.

When a company enters VA, it has a short ‘breathing space’ within which it can develop a strategy to deal with its insolvency. Generally, the strategy will focus on alleviating the effects of financial distress by generating positive cash flows so as to reduce the gap between available cash and current obligations. Of course, a company’s ability to resolve its problems at the time of entering VA will be significantly affected by its past performance and its current financial position. If circumstances at the time of entering VA are such that the company has deteriorated the point where it is ‘hopelessly’ insolvent, the VA process will do little more than delay an inevitable liquidation. It follows that decision-making by directors as to when their company should be placed into administration is critical to the effectiveness of the VA regime. This paper addresses the important issue of whether VA is used by directors as a ‘last resort’ or as part of a timely governance strategy. To this end, exploratory analysis is presented of the change in financial characteristics of a sample of listed public companies over the critical time immediately prior to their entering VA. The analysis focuses on the question: what do the observed patterns of change indicate regarding the company’s prospects for reorganisation once it enters VA? If this analysis suggests that reorganisation prospects are significantly diminished, then it is arguable that the directors should have taken more timely action. Since the introduction of the VA procedure in 1993 there has been little empirical examination of its operation. This paper adds to the few empirical studies

of the VA process. Arguably, the lack of empirical studies is a consequence of the difficulty associated with obtaining necessary data. However, there are now a number of listed companies have been subject to VA. Because these companies are required to release public information, they have become ready source of data for empirical analysis.

The broad motivation for this research is to improve understanding of the governance of distressed companies, which is important given the economic cost of business failure. Specifically, the results of the analysis presented may serve to inform decisions about policy designed to ensure that directors of distressed companies take timely action to resolve their companies’ financial problems.

2. A Model of Financial Distress Management

An important consideration for this research is the selection of financial characteristics to be used in the empirical analysis. Prior relevant literature is a useful guide in making this choice. In particular, a model of financial distress management presented by John provides a useful reference. The model proposes that financial distress arises when a firm’s liquid assets are not sufficient to meet its current obligations, and that managing financial distress requires action to rectify the mismatch. The relevance of this model in the Australian context is underscored by the adoption of a ‘cash flow’ test of solvency for Australian companies. John noted that the actions that can be taken to address insolvency are: (1) the sale of non-current assets to generate liquid assets to meet current obligations; (2) the renegotiation of debt contracts so that current obligations are reduced or deferred; or, (3) the issue of new financial claims against future cash flows so as to improve liquidity. The action chosen will depend on the relative costs and benefits of each mechanism.

The usefulness of the John model is supported by prior empirical research. Studies that have examined the operation of VA and the similar US Chapter 11 administration procedure have shown that ability to borrow additional funds or renegotiate debt contracts affects prospects for reorganisation. Other modelling has demonstrated that firms with better earnings prospects are more likely to obtain funds from external borrowing, which assists them to emerge successfully from bankruptcy. Moreover, prior research has shown that a firm’s ability to reorganise assets so as to improve liquidity is important to its reorganisation prospects. In particular, studies by Ofek, Asquith et al., and Brown et al. show that asset sales are an important restructuring mechanism for distressed firms.

The literature demonstrates that the John model is useful in identifying variables that are relevant to financial distress management. Accordingly, the model is relied on in selecting variables included in this study. The rationale for variable choice in this study is that they measure current and potential activity in the three areas identified by the John model: asset sales, debt restructuring, and ability to secure new funding. An detailed explanation of variable choice follows.

3. Variable Selection

Activity in the area of asset sales is measured by the company’s reported investing cash flow. Net investing cash outflow shows a continued acquisition of non-current assets which represent a useful source of funds in VA, either by their sale or through their productive use. A net investing cash inflow prior to VA shows the disposal of non-current assets. While such disposal may improve the company’s liquidity by providing much-needed funds to meet current obligations, it is arguable that the disposal of significant non-current assets would be better governed within the VA process. The orderly dealing promoted by the VA process would serve to minimise the likelihood of ‘fire-sale’ activity by the company.

To assess capacity to renegotiate debt contracts, analysis is presented of changes in leverage and liquidity. A company’s ability to renegotiate debt contracts so as to reduce current obligations will be constrained by the overall level of debt in its financial structure. As debt levels increase, the likelihood that lenders will be prepared to renegotiate contracts will decrease. In a similar manner, decreasing liquidity will have a negative effect on a company’s ability to manage payments to creditors. In particular, unsecured creditors will generally require strict adherence to credit terms once the company’s distress becomes apparent.

Securing additional sources of funds will be affected by the likelihood of the company generating operating cash flows in the future. Accordingly, measures of operating cash flows and accrual earnings are included as proxy measures of future company performance. Table 1 summarises the variables included in the analysis.

4. Sample and Data

The first stage of developing the sample for this study was to identify listed public companies that had entered VA. This was accomplished by searching the Aspect database for an announcement of the appointment of a voluntary administrator to the company. This database provides data for listed companies from 1997 onward. From companies identified, a sub-sample of companies was selected for which financial data was available for both the year in which the company entered VA and the year immediately prior. The final sample comprised 39 companies. The years of entry by the companies into VA occurred between 1998 and 2005, and comprised: 1 company in 1998, 4 in 2000, 6 in 2001, 7 in 2002, 7 in 2003, 13 in 2004, and 1 in 2005.

<table>
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<td>Non-current asset sale activity</td>
<td>Investing Cash Flows (ICF)</td>
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<td>Debt contracts – leverage and liquidity</td>
<td>Total Liabilities to Total Assets (TLTA) Current Assets to Current Liabilities (CACL)</td>
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<tr>
<td>Performance – cash flows and accrual earnings</td>
<td>Cash from Operations (CFO)</td>
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<td></td>
<td>Cash Receipts (RCPTS)</td>
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<td>Cash Payments (PAYTS)</td>
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<td>Earnings (EARN)</td>
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Table 1: Variables in the Analysis

December 2007
5. Data Analysis

5.1 General Characteristics

Voluntary administration concluded with liquidation for eight of the sample companies, while the remaining 31 companies entered a deed of company arrangement. Among the eight liquidated companies, one had entered a deed of company arrangement (DOCA), however, the terms of the deed were not complied with and a liquidator was later appointed. Another of the companies that entered a DOCA later made an announcement that the deed had not been complied with and there was a possibility the company would be liquidated. However, the deed was still in place at the time of analysis. Data for the length of time the companies were in VA are summarised in Table 2. The mean and median values for the length of VA were calculated as the number of calendar days between the appointment of the administrator and execution of a DOCA or appointment of a liquidator.

Overall, the result is consistent with the objective of providing a relatively short moratorium on creditors’ claims against the insolvent company\(^\text{10}\). Of some concern however is the difference between the length of VA for companies that entered a DOCA and companies that liquidated. The disaggregated mean and median values of days in administration shows that a decision to liquidate took a greater time. Of the eight companies in the sample that liquidated, four were in VA for 6 months or longer before the company’s fate was decided.

Table 3 provides a summary of other salient characteristics of the sample companies.

Of the seven companies that had a receiver and administrator appointed, only one concluded VA with liquidation. This may reflect the discipline that results from oversight of a major creditor that is able to monitor company activity and protect its security interest by appointment of a receiver. Such discipline may result in more timely action being taken by directors. Instances of legal action being brought against company officers and the occurrence of a second VA were infrequent within the sample.

Company size as measured by assets and liabilities are reported in Table 4 below. The sample companies’ total liabilities were relatively stable, whereas there was a statistically significant decline in total assets. This suggests a general overall deterioration in the value of the company over the period leading up to VA.

5.2 Financial Characteristics

Table 5 below summarises the change in financial characteristics of the sample companies. Also reported are the results of a Wilcoxon Signed Ranks test of the significance of the change from \(t_{-1}\) to \(t_0\) for each variable. This non-parametric test was considered suitable due to the non-normal distribution of variables in the sample.

Investing cash flow (ICF) data shows that in year \(t_{-1}\), ninety percent of the sample companies had negative flows. This shows investment in non-current assets by the sample companies. However, analysis of change in investing cash flows showed that a statistically significant number of companies reported decreasing investing cash outlays from year \(t_{-1}\) to year \(t_0\). This means that as VA approached, companies were either disposing of non-current assets, or reducing their cash outlays on non-current assets as they grappled with the effects of financial distress.

Leverage data (TLTA) confirms the distressed and worsening balance sheet position of the sample companies in the time prior to appointment of the administrator. The deterioration of leverage was statistically significant. Leverage of a value greater than one suggests that, from a balance sheet perspective, a company is ‘hopelessly’ insolvent. Nine companies’ leverage value increased to one or more, which highlights the overall worsening debt position for companies in the sample.

During the time between \(t_{-1}\) and \(t_0\), the sample companies’ mean liquidity (CACL) also deteriorated substantially, indicating fewer available funds available to meet current obligations. Increased debt, asset sales, and reduction in investment did not improve the sample companies’ capacity to meet obligations as they became due.

The mean values for Cash from Operations (CFOTA) and Earnings (EARNTA) were negative in both periods, and declined from \(t_{-1}\) to \(t_0\). The decline for earnings occurred at almost the rate of the cash flow measure, and was statistically significant for each variable. This non-parametric test was considered suitable due to the non-normal distribution of variables in the sample.
significant. These measures of earnings and cash flows suggested that the sample companies were unlikely to be able to continue to fund future operations from existing business activity. The values for Cash Receipts (RCPTS) and Cash Payments (PAYTS) provide disaggregated data for Cash from Operations. RCPTS increase by 41 percent, while PAYTS increase by 25 percent. This result suggests that companies were not applying cash receipts to repay current liabilities, which is consistent with the deterioration of the companies’ liquidity as discussed above.

Considered together, the results indicate that the sample companies were experiencing extreme distress over the period prior to entering VA. The results do not indicate any meaningful strategy was adopted by directors over the critical period of analysis. Furthermore, the position of the sample companies deteriorated in key areas which indicate capacity to implement reorganisation strategies. The results point to a lack of timely decision-making, and suggest that directors of the sample companies used VA as a last resort.

6. Summary and Conclusions

Overall, the brief exploratory analysis presented in this paper points to a substantial decline in financial position and performance for a sample of public listed companies that entered VA. This decline was manifest across a range of financial characteristics that relate to a company’s capacity to reorganise. For the sample companies, leverage increased significantly and, for many, reached levels that are indicative of their being ‘hopelessly’ insolvent from a balance sheet perspective. The sample companies’ liquidity also decreased, along with negative and deteriorating earnings. While there was some indication that additional funds were available from the sale of non-current assets or from a reduction in investment in non-current assets, this did not improve the companies’ capacity to meet their current obligations. The patterns of decline and the extent of observed deterioration was such that the companies’ ability to reorganise in VA was impaired. The analysis suggests that there was little or no value in allowing the companies to continue trading.

Overall, the analysis raises a question about the timeliness of the decision to enter VA. It is apparent that more timely action by directors would have served to limit the extent of harm resulting from their company’s failure. The findings have implications for the policy settings associated with the VA legislation. It may be appropriate that legislative reform focus on providing incentives to improve decision-making. This paper also points to further fruitful avenues for research related to the VA process. For example, a detailed study of the motivations of directors and the nature of their decision making processes could be useful in determining appropriate policy settings in this area.

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<table>
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<tr>
<th></th>
<th>Mean_{t-1}</th>
<th>Mean_{t0}</th>
<th>t-1</th>
<th>t0</th>
<th>Increase {(t-1 to t0)}</th>
<th>Decrease {(t-1 to t0)}</th>
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<td><strong>Earnings (EARN)</strong></td>
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<td>-0.342</td>
<td>13</td>
<td>26*</td>
<td>0</td>
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</tr>
</tbody>
</table>

Table 5: Financial Characteristics
** Denotes that the change is significant at $p<.001$ based on a Wilcoxon Signed Ranks test.
* Denotes that the change is significant at $p<.05$ based on a Wilcoxon Signed Ranks test.
References

1. The objectives of voluntary administration are outlined in the *Corporations Act 2001* (Cth) s 435A.


5. If the company is to remain solvent, then it must be able to satisfy the definition set out in s 95A(1) of the *Corporations Act 2001* (Cth), which states: ‘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’.


10. See Division 6 of Part 5.3A, section 440A - 440D the *Corporations Act 2001* (Cth).
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Organisations, Control Systems and Fraud

S Cuganesan & D Lacey

This paper examines how organisations are responding to the threat of identity fraud and the challenges that they face in doing so. Quantitative data were collected from 29 Australian organisations. The majority of organisations sampled emphasised the ‘anticipation’ of identity fraud and, in particular, activities performed in relation to prevention, deterrence and detection. Furthermore, organisations with more sophisticated preventative controls reported lower losses. Counter-intuitively on first glance, organisations with higher detection capabilities reported higher losses (other things being equal). The contributions of this paper are two-fold. Firstly, a framework is presented that both operationalises the identity fraud construct and facilitates the measurement and understanding of organisational responses in terms of a ‘value-chain’ of activities. Secondly, exploratory evidence is presented on how organisations are responding to identity fraud and the efficacy of these responses.

Taxation of Infrastructure

G Mackenzie

Infrastructure in Australia is under strain from two influences. First, the existing limited infrastructure is unable to keep pace with economic growth and, secondly, the demand for health and welfare infrastructure because of an ageing population. There are no special rules for the taxation of infrastructure in Australian taxation law, except in very limited circumstances. The taxation of infrastructure assets is governed by the general taxation rules that apply to all other similar types of assets. However, what can be said about infrastructure taxation is the number of anti tax avoidance rules that it has attracted.

Does Competition Drive Credit Risk and Performance in Financial Services Lending? An Australian Investigation

J Donato

Increased competition in the Australian lending market over recent years has forced authorised deposit-taking institutions (ADIs) to attract and retain customers by means of relaxing lending standards. As larger amounts are granted, it appears credit is more easily available to borrowers in comparison to the past. The industry has further experienced significant growth in non-conventional products, such as low-documentation loans, which are generally offered at rates close to the standard rate for traditional loans. While these changes may not create problems during times of strong economic conditions, they are likely to exacerbate loan losses if economic conditions deteriorate, as it seems as if ADIs have taken on more risk in order to stay competitive. The aim of this paper is to examine how lending market competition affects banking institutions’ credit risk and performance within Australia. Thus, I hypothesise that increased competition leads to a rise in credit risk and that increased competition tends toward a reduction in performance, I test these hypotheses using linear regression.