BRACING FOR THE THREAT OF INSOLVENCY: WILL THE CASH RUN OUT?

With Covid-19 still impacting businesses and wrongful trading rules back in effect, counsel must work with companies and directors to ensure business decisions stand up to scrutiny

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As a result of prolonged shutdowns and changing consumer demands, many organisations continue to face problematic declines in revenues and cash shortages as the pandemic persists. As short- and long-term obligations become due – and the lifelines of government support programmes dry up – companies will face increasing pressure to effectively manage cash with the threat of insolvency looming large for many. In light of these challenging circumstances, companies would be prudent to reassess their forecasting strategies to ensure forecasts are sufficiently robust, providing decision-makers with sufficient visibility to make operational decisions that can help keep the business afloat through potential cash shortages.

The current environment

Reports estimate the UK economy shrank over 20 per cent in the second quarter of 2020 compared with the first, and businesses across industries are still hurting as we approach year-end. Companies are implementing a myriad cash preservation measures, including cutting costs, renegotiating contracts, and taking advantage of government furlough and business loans. Government-backed programmes may serve to reduce unemployment and bankruptcy in the short term, evidenced by a decline in overall insolvencies filed in the UK thus far in 2020, but relying on these may just be delaying the inevitable for many companies struggling to return to profitability. Companies need to manage their cash to keep paying short-term costs (e.g. rents, utilities, and insurance), as well as plan for long-term obligations such as repaying government support loans or previous debt.

Cash forecasting through crises

Even the best cash-management strategies alone cannot save a company that is inevitably doomed (think: zombie companies), but robust cash-flow forecasts allow troubled organisations to make better decisions that may keep them afloat. Managers can react more nimbly to unplanned events with a forecast and can better understand how to leverage the components of working capital to manage a positive cash balance. Companies navigating turbulent circumstances should consider implementing the following forecasting strategies, engaging independent advisers where needed:

- **Focus on cash:** while forecasting net income and other profitability metrics is important, during challenging times it is even more important to forecast cash flows, since cash is the lifeblood. The forecast should show when the company expects to collect on receivables (e.g. considering historical patterns), and the timing of disbursements should be planned judiciously to avoid shortfalls.
- **Real-time road map:** companies often put forecasts in the drawer, checking progress against performance targets only occasionally. When cash is tight, companies should instead use the forecast as a forward-looking guide (e.g. what payments to make this week). Managers should frequently refresh forecasts for future periods to reflect actual activity and refine assumptions.
- **Shorten forecasting intervals:** though cumbersome, short forecasting intervals (e.g. weekly or bi-weekly) provide greater visibility into periods where cash may be especially tight. Management can then make precise decisions to avoid shortfalls, such as negotiating extended payment terms on a future inventory purchase.
- **Scenario analysis:** building forecasts with the flexibility to simultaneously analyse multiple scenarios takes on increasing importance during challenging circumstances. Companies may wish to model, for example, the impact of potential future waves of pandemic shutdowns. An experienced external advisor can support with developing these more sophisticated scenarios by leveraging data analytics and advanced modelling techniques.

Avoiding missteps in insolvency

Companies will, of course, hope to avoid insolvency (i.e. assets are insufficient to meet existing obligations), but a robust forecasting process can be beneficial if a company does finds itself in this position. Every penny spent in prior months may be subject to scrutiny in insolvency proceedings, so adhering to planned disbursements set forth in a forecast can help companies avoid making payments that may later be viewed as giving unfair preference to certain parties.

Further, detailed cash forecasts can help companies remain alert to the company's status as insolvent in order to avoid civil penalties for wrongful trading, which occurs when company directors continue to do business when they know (or should have known) the business was insolvent. The UK's Corporate Insolvency and Governance Act 2020 temporarily suspended parts of insolvency laws, including relaxing wrongful trading rules from 1 March to 30 September 2020, but now companies must again be vigilant.

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