

Corporate Insolvency in the Australian Construction Sector

Key findings from ASIC insolvency data 2010 - 2011



1,862 the **number** of construction industry insolvencies in 2010 / 2011

23% the percentage of all Australian insolvencies that are in the **construction** sector

54% the percentage of Australian construction insolvencies that occur in **NSW**

\$ 2.64 billion the estimated amount of money **lost by creditors** in construction related insolvencies annually.

The six most commonly reported **reasons** cited for corporate failure in the construction sector.

1. Inadequate cash flow or high cash use
2. Poor strategic management of business
3. Poor financial control including lack of records
4. Poor economic conditions
5. Trading losses
6. Under capitalisation



Zero the most likely return to unsecured creditors in the event of a building company collapse

The construction industry is regarded as one of the highest risk sectors in which to operate.

During the 1992 NSW Building Royal Commission, Commissioner Roger Gyles heard evidence that *the average life of a construction company in Australia was just 7 years*. While it is generally accepted that newly incorporated entities pose the highest risk, this year (2012) has already witnessed the demise of a large Australian contractor that has been around for over 100 years.

Adding to the complexity of the problem is the phenomenon of 'phoenix' companies where directors of failed companies re-emerge to cause further harm to the industry. All said there is much to be done to reduce the rate of insolvencies and the resulting damage.

Despite many legislative reforms the unfortunate fact remains that the construction sector is still well **overrepresented** in insolvency statistics. The effect of these corporate failures is that large sums of money owed to creditors are lost and clients are left with the unenviable task of dealing with payment claims and contractual issues while trying to get their projects completed.

For over 10 years Kingsway Financial Assessments has been at the forefront of risk management having successfully minimised potential headaches for its clients by filtering out contractors under financial stress, at risk of insolvency or exhibiting potential risks as a result of their financial structure. This is achieved by carefully examining and reporting on up-to-date financial information pertaining to tenderers prior to the award of a contract and in some cases providing on-going monitoring.

This report is possible thanks to significantly improved data collection from external administrators by the Australian Securities & Investments Commission (ASIC). Consequently, we are now able to gain a far better insight into the extent of the insolvency problem. In this report prepared by Kingsway, data from ASIC's recently released insolvency statistics *Series 3.2 External administrators' reports for selected industries* are examined with a focus on the 'construction' category.

Although we may think of statistics as just numbers and percentages, we should always bear in mind that each and every insolvency is likely to have adverse and often a devastating impact, to a greater or lesser extent, to a variety of parties including, employees, clients and secured and unsecured creditors.

Some of the adverse effects on third parties are as follows:

Employees: In addition to losing their jobs, employees may lose superfund contributions, leave entitlements including long service leave and wages less amounts received from the federal government (where applicable).

Clients: Experience delays in the completion of their projects and the additional costs of having to engage new contractors and in time subcontractors. They may be subjected to claims from unpaid subcontractors and receive liquidated damages claims in respect of late completion from prospective tenants. For Government clients there are also political outfall costs for high profile insolvencies on public sector jobs.

Secured creditors: Even with the introduction of the new Personal Property Security Register (PPSR), there is a pecking order in terms of repayment the security held may not always fully meet the liabilities. Secured creditors such as banks, finance companies and the ATO do not always recoup their losses.

Subcontractors: Subcontractors are generally unsecured can be the most severely affected. Statistically they are likely to receive zero cents in the dollar in administration dividends for work completed or retentions held on completed work. When a new head contractor is engaged to complete the job they are unlikely to honour previous claims and may choose new subcontractors to complete the works. Non payment on just one major project can lead to the demise of a subcontractor and their livelihood.

Given the findings here, unsecured creditors such as subcontractors and suppliers would be well advised to invoke relevant State based Security of Payment legislation as early as possible without waiting for additional months of payment claims to be ignored, hence limiting their potential losses.

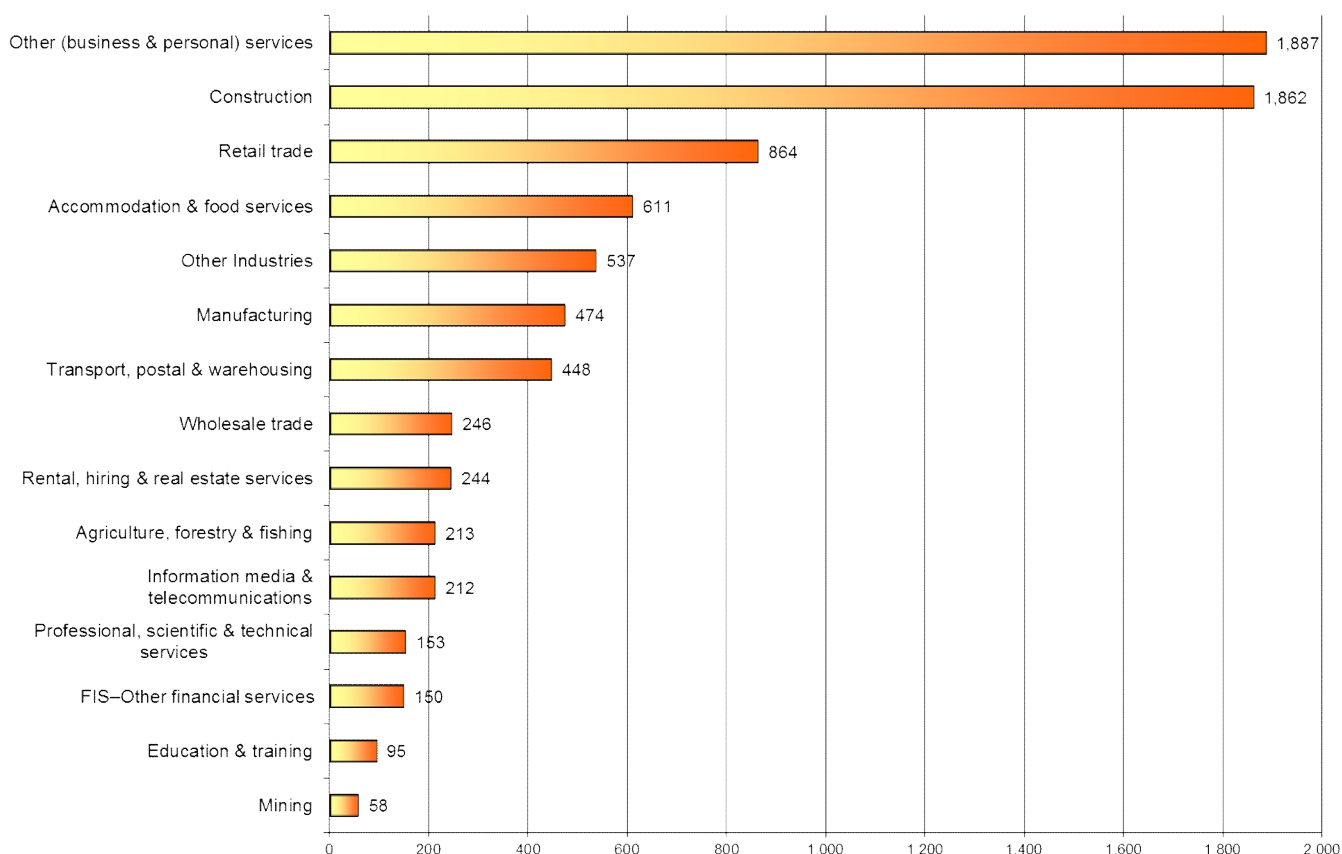
Suppliers: Unfixed materials on site not paid for can generally be removed by the supplier but the logistics and proof of ownership can present difficulties. Reclaiming good fixed on site are much more problematic. While securities over goods can be set in place they are not always realisable.

Social considerations: As yet the social impact of construction industry insolvencies has not been quantified or measured. One can only imagine the devastation to those parties and their families who lose significant amounts after these events. This is a matter considered so serious that there is currently government funded research being initiated for the impact to be assessed.

Almost 2,000 construction sector insolvencies in 2010/2011

There were a total of **8,054** Initial external administrators reports lodged at ASIC between 1 July 2010 and 30 June 2011. Of these **1,862** companies (23.1%) related to companies in the construction sector making it the largest single category behind the composite category 'Other (business & personal) services'. In the past 3 years 'Construction' was the largest overall category.

Figure 1. Initial external administrators' reports (1 July 2010 - 30 June 2011)



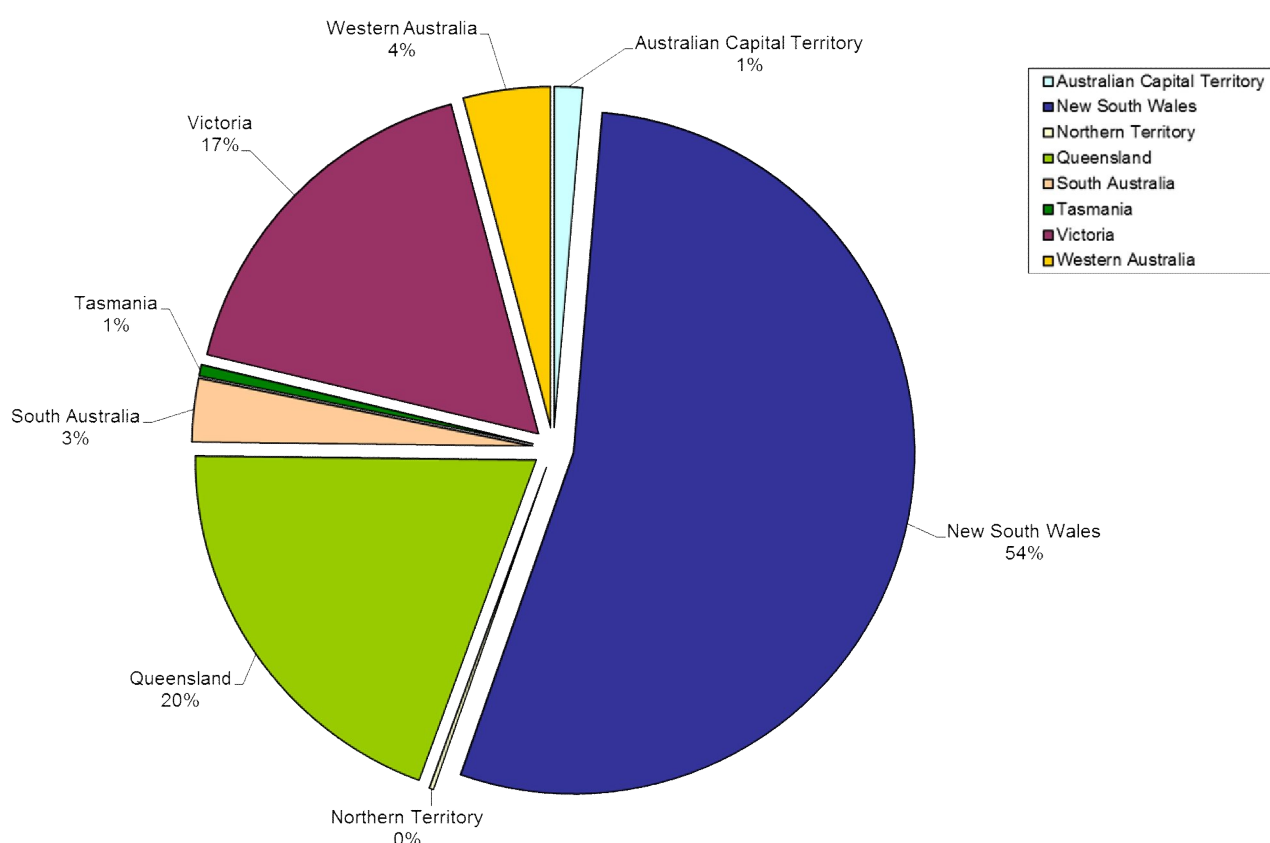
State by State analysis

The chart below shows the distribution of the states in which companies entering external administration were registered. New South Wales exhibited the highest percentage of insolvency reports (54%) followed by Queensland (20%) and Victoria (17%).

Given that there are likely to be a similar number of construction firms in NSW and Victoria, this finding is puzzling. Some have commented that one likely cause is that the NSW WorkCover Authority is vigilant in winding up companies that do not pay their premiums, and that many of those wound up in NSW are quite small operations.

Australia has experienced a number of large and politically sensitive construction insolvencies in the past year and the ASIC statistics for 2010-2011 show that 10% of failed construction companies owed secured creditors over \$1,000,000 and in 14% of the cases owed unsecured creditors over \$1,000,000. It is worth noting that 24% of the failed companies had more than 25 unsecured creditors.

Figure 2. Initial external administrators' reports by region (1 July 2010 - 30 June 2011)



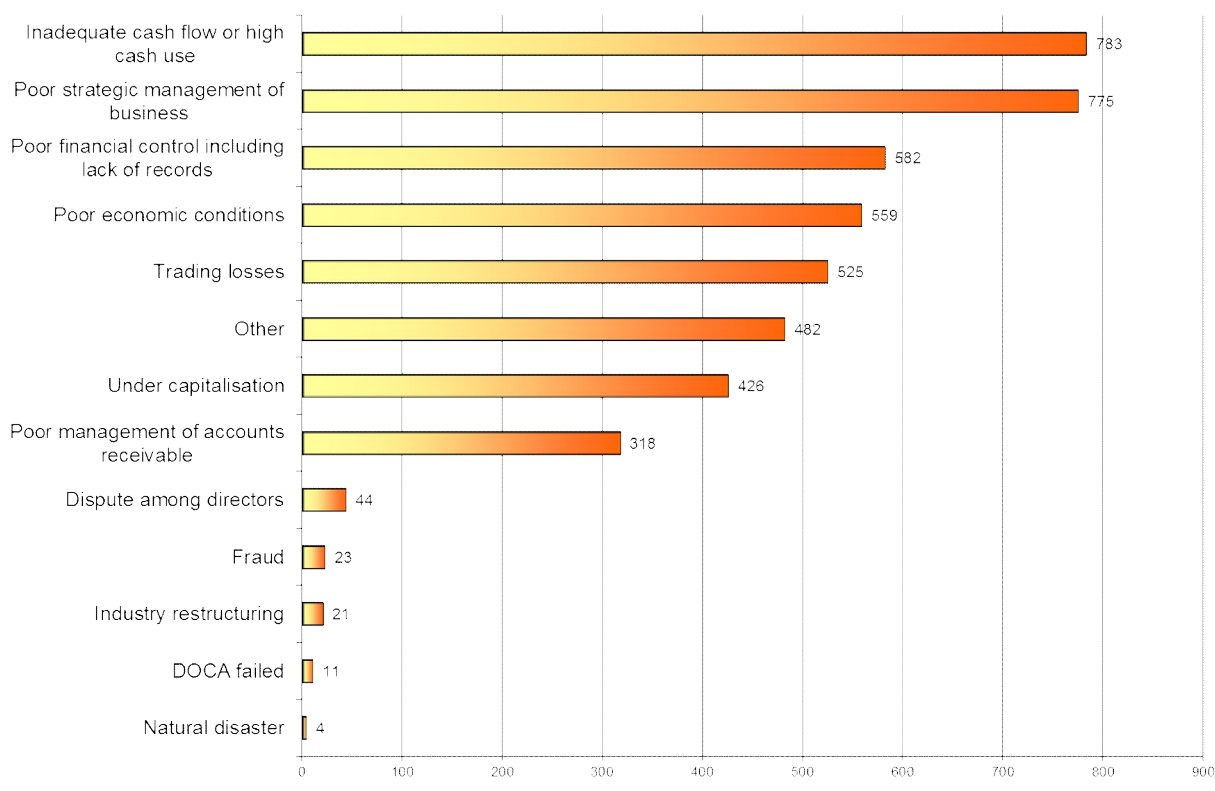
Why did these companies fail ?

Ask any failed contractor what went wrong and inevitably they will tell you it was not their fault. When filing a report, External Administrators are asked by ASIC to nominate the main causes for failure - multiple causes can be selected. Invariably, other than those who are caught out by the domino effect of an upstream contractor failing, the problem lies with management and lack of adequate financial controls (See Figure 3).

As financial assessors of companies for projects, Kingsway sometimes encounters companies that are unable to provide up to date financial records in a timely manner or produce management accounts that are obviously flawed. These serve as an initial warning sign to potential clients about possible financial problems that may ensue. In many instances clients do not take heed of the early warning signs because of time constraints in awarding contracts.

Other areas of concern most frequently indentified in our financial assessments are working capital deficiencies, **related entity loans**, trading losses, high levels of debt and poor management of receivables. It is not uncommon to find significant related entity loans as current assets on a balance sheet of a building contractor. Without a thorough examination of the related parties' ability to repay the loans in the short term, one should always be sceptical of the quality of a contractors claimed working capital figures. These related parties may be involved in high risk property development projects which can easily come unstuck.

Figure 3. Nominated causes of company failure, construction (1 July 2010 – 30 June 2011)



Was misconduct involved ?

ASIC collects data from External Administrators about any suspected breaches of the corporation's law or breaches of directors' duties both at the time of appointment and during their appointment.

During the period that external administrators were dealing with the 1862 administrations in the construction industry, they reported 3,422 possible instances of criminal misconduct or alleged breaches of civil obligations.

In the case of suspected breaches ASIC requests the administrators to investigate further and attempt to obtain documentary evidence of the misconduct. As one would imagine, obtaining this evidence is difficult. So while the number of breaches was high and companies had multiple breaches, there were only **182** reports filed where an external administrator was able to obtain **documentary evidence** of the breaches and recommended the case warranted further inquiry by ASIC. This is equivalent to just 10 % of the reports filed.

In the construction sector the most common forms of possible **pre-appointment** criminal misconduct were breaches of:

1.	Section 588G(3)—Insolvent trading	164 records
2.	Sections 286 & 344(2)—Obligation to keep financial records	144 records
3.	Section 184—Good faith, use of position and use of information—Directors', officers' and employees' duties	48 records

In the construction sector the most common forms of possible **post-appointment** criminal misconduct were breaches of:

1.	Section 530B—Requirement to provide liquidator with company's books	257 records
2.	Sections 429, 438B & 475—Report as to company's affairs	252 records
3.	Section 530A—Officers to help liquidator	217 records

In the construction sector the most common **alleged breaches of civil obligations** were:

1.	Section 588G(1)–(2)—Insolvent trading	901 records
2.	Sections 286 & 344(1)—Obligation to keep financial records	681 records
3.	Section 180—Care and diligence (339) Directors' and officers' duties	339 records
4.	Section 181—Good faith—Directors' and officers' duties	144 records
5.	Section 182—Use of position—Directors', officer's and employees' duties	118 records
6.	Section 183—Use of information, Directors', officers' and employees' duties	43 records

Monetary deficiencies and dividends

The ASIC data available contains detailed tables showing the assets and monetary deficiencies at the date of the initial administrator's report in 13 categories shown below. Not all of these are discussed in this article but are available in the ASIC data published on their website.

- i) Assets
- ii) Liabilities
- iii) Deficiencies**
- iv) Unpaid wages
- v) Unpaid annual leave
- vi) Unpaid pay in lieu of notice
- vii) Unpaid redundancy
- viii) Unpaid long service leave
- ix) Unpaid super
- x) Amount owed to secured creditors
- xi) Amount of unpaid taxes and charges
- xii) Amount owed to unsecured creditors
- xiii) Estimated dividends to unsecured creditors

In relation to the above categories we note the following regarding deficiencies to creditors.

Figure 4. Deficiencies in assets, construction, no. of reports (1 July 2010 - 30 June 2011)

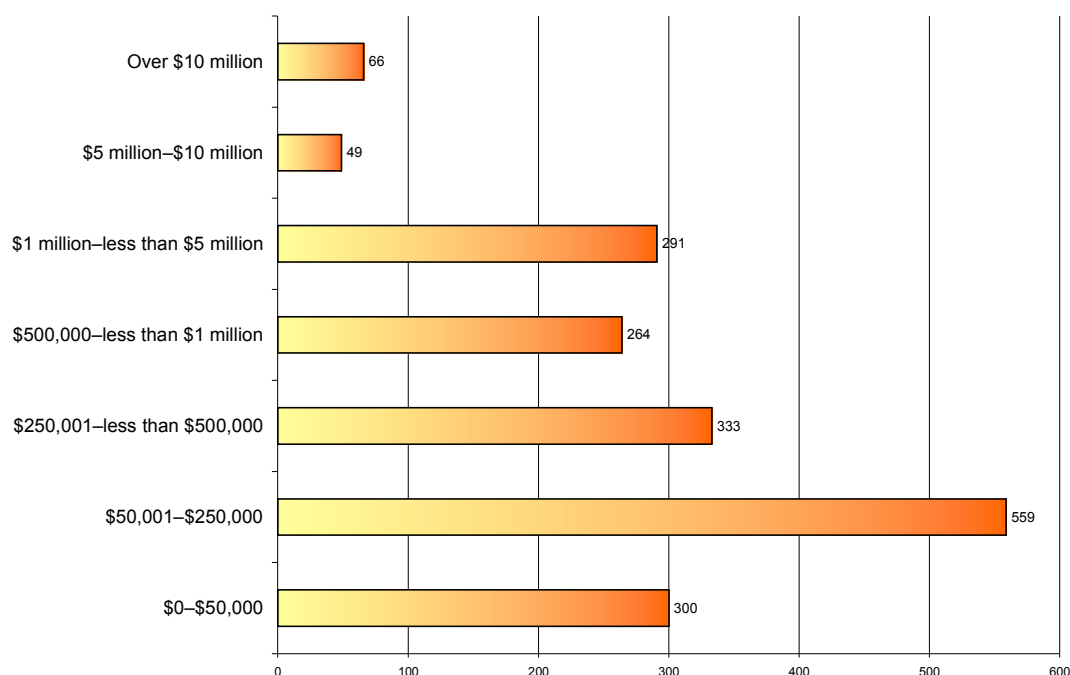


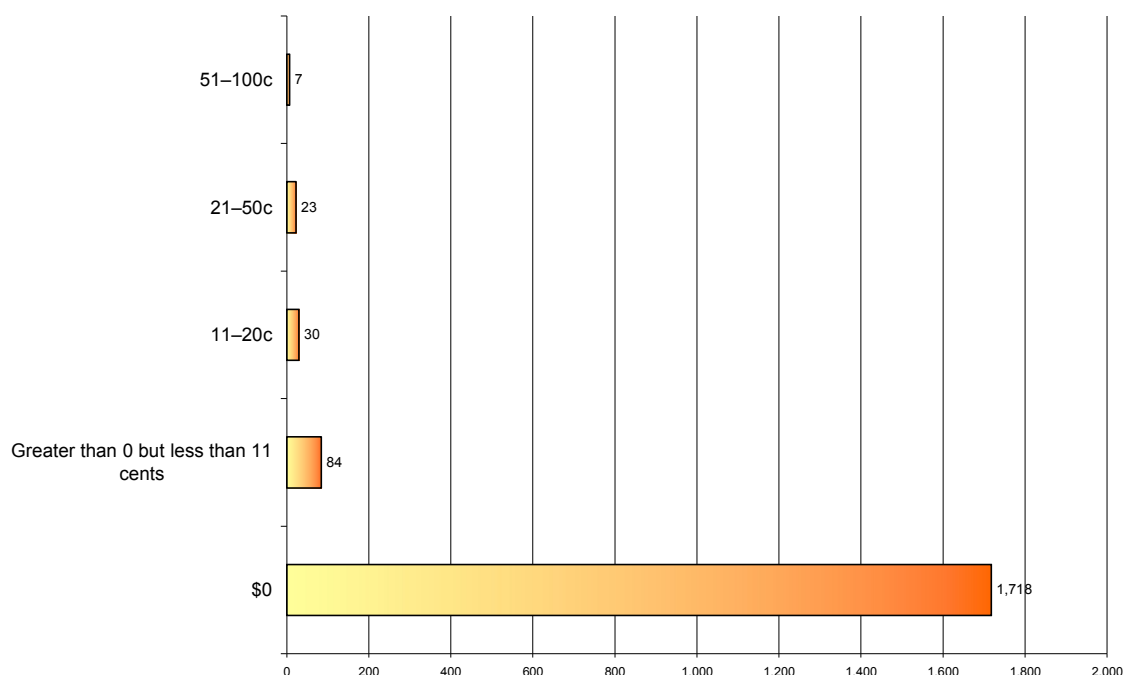
Figure 4 shows the number of companies in the construction sector that had monetary deficiencies (i.e. assets less liabilities) in each value range. Two thirds had a deficiency of less than \$500,000, with 14% having deficiencies of between \$500,000 and \$1 million, 19% had deficiencies of between \$1 million and \$10 million and 4% had deficiencies of over \$10 million.

While the exact number cannot be calculated from this data, taking the number of insolvencies in each category and multiplying by the midpoint in each category (using an average of \$15 million for the highest category) it can be estimated that the overall annual deficiency for insolvencies in the construction sector is **\$2,644,725,000**. It is estimated by that this amount is roughly evenly divided amongst secured and unsecured creditors.

Sadly, there is very seldom a return to unsecured creditors in the case of an insolvency. Figure 5 below shows that in **92%** of cases, there is **no return** to unsecured creditors whatsoever.

We emphasize that unsecured creditors such as subcontractors and suppliers would be well advised to invoke relevant State based Security of Payment legislation early in the piece without waiting for additional months of payment claims to be ignored, hence limiting their losses.

Figure 5. Estimated cents is the dollar returned to unsecured creditors, construction insolvencies, (1 July 2010 - 30 June 2011)



The data use in the above analysis was source by Kingsway from the Australian Securities and Investments Commission (ASIC) from the following location:

<http://www.asic.gov.au/asic/asic.nsf/byheadline/Insolvency-statistics-Series-3.2?openDocument>

Kingsway Financial Assessment's services

Kingsway Financial Assessments provides its clients with access reliable and independent financial assessment reports help in the selection of successful tenderers.

Our role is to evaluate tenderers' financial capacity to deliver projects, goods and services, without risk of financial distress or insolvency.

Kingsway's services can help you to:

1. Assess tenderers' financial capacity to undertake construction projects,
2. Assess the eligibility of contractors for prequalified contractor panels,
3. Establish suitable lists of contractors to invite to tender.

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