

Corporate Insolvency in the Australian Construction Sector

ASIC insolvency data

Key findings for 2009 / 2010

1,905 the number of construction industry insolvencies in 2009/2010

24% the percentage of all insolvencies that are in the construction sector

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

\$ 2.5 billion the estimated amount of money lost by creditors in construction related insolvencies annually.

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

The five most commonly reported reasons for corporate failure in the construction sector.

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

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

Many of us will recall the 1992 Building Industry Royal Commission where Commissioner Roger Gyles heard evidence that the average life of a construction company in Australia was just 7 years.

Despite many legislative reforms since then, the unfortunate fact remains that the construction sector is still well overrepresented in insolvency statistics. The outfall of this is that huge sums of money owed to creditors are lost and clients are left with the unenviable task of dealing with payment claims while trying to get their jobs completed.

As a result of significantly improved data collection from external administrators by the Australian Securities & Investments Commission (ASIC), we are now able to gain a far better insight into the extent of the problem. In this article, supporting data from ASIC's recent report "*Insolvency Statistics: External Administrators Reports 1 July 2007- 30 June 2010*" is examined with a focus on the construction sector.

Although we may think of statistics as hard numbers, one should always bear in mind that each insolvency is likely to have a negative and often devastating impact to a variety of parties including, employees, clients and secured and unsecured creditors.

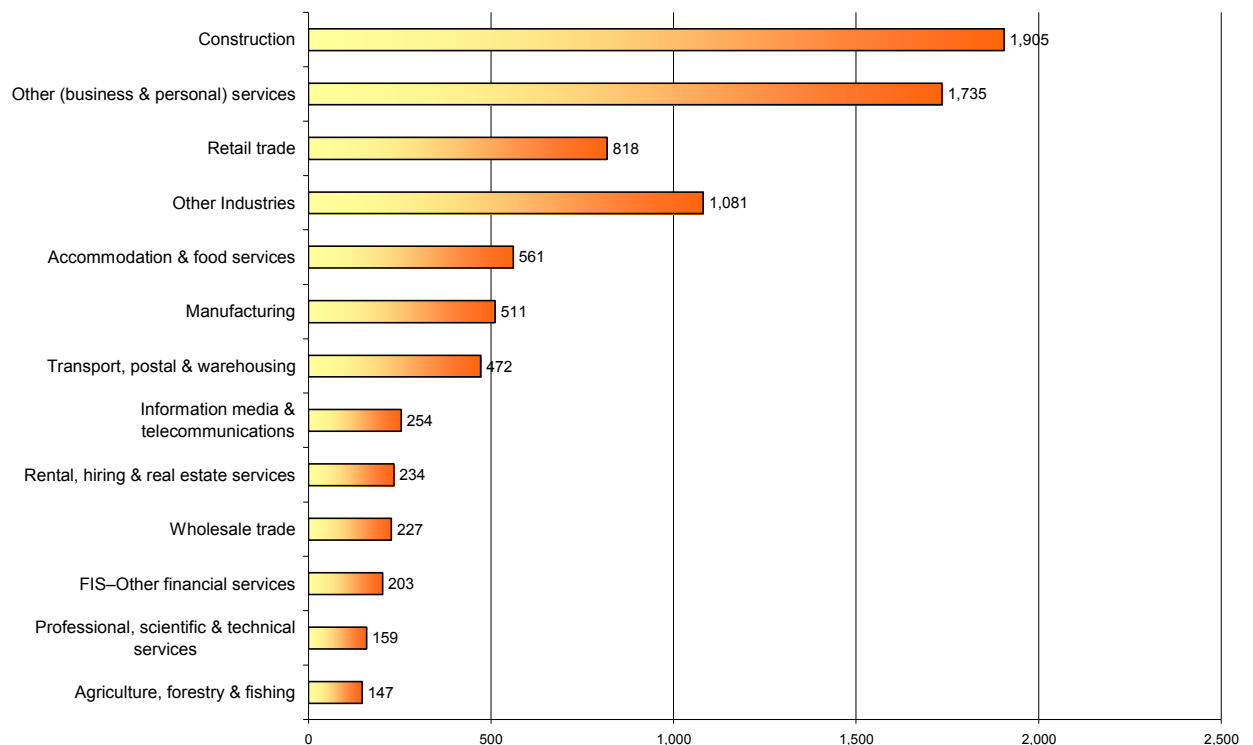
The analysis by Kingsway that follows overleaf unpacks some of the raw data released by ASIC in December 2010.

Almost 2,000 construction sector insolvencies in 2009/2010

There were a total of 7,903 Initial external administrators reports lodged at ASIC between 1 July 2009- 30 June 2010. Of these 1,905 companies (24%) were reported as being in the construction sector making it the largest single category for at least the last 3 years [2008-2009 1,787 (23%), 2007-2008 1,517 (23%)].

Interestingly, this data covers the period of significant activity generated by the National Stimulus Package which included the Building the Education Revolution (BER) program. Anecdotal evidence collected by Kingsway indicates that some construction firms failed during the stimulus cycle because they were awarded (and took on) more work than they were able to handle with their resources and management skills, particularly in the area of project and financial management.

Figure 1. Initial external administrators' reports (1 July 2009- 30 June 2010)



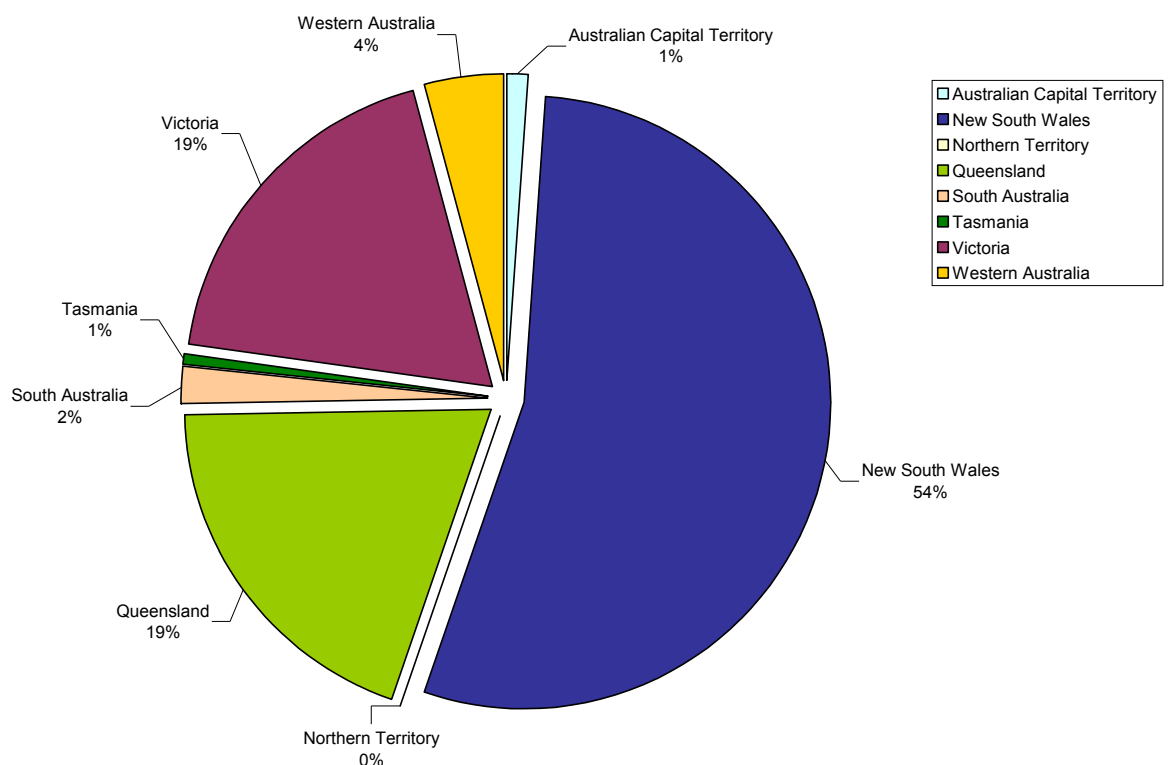
State by State analysis

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 Victoria and Queensland (19% each).

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.

Nonetheless NSW has experienced a number of large and politically sensitive construction insolvencies and the ASIC statistics show that in 2009-10, 10% of failed construction companies owed secured creditors over \$1,000,000 and 12 % owed unsecured creditors over \$1,000,000.

Figure 2. Initial external administrators' reports by region (1 July 2009- 30 June 2010)



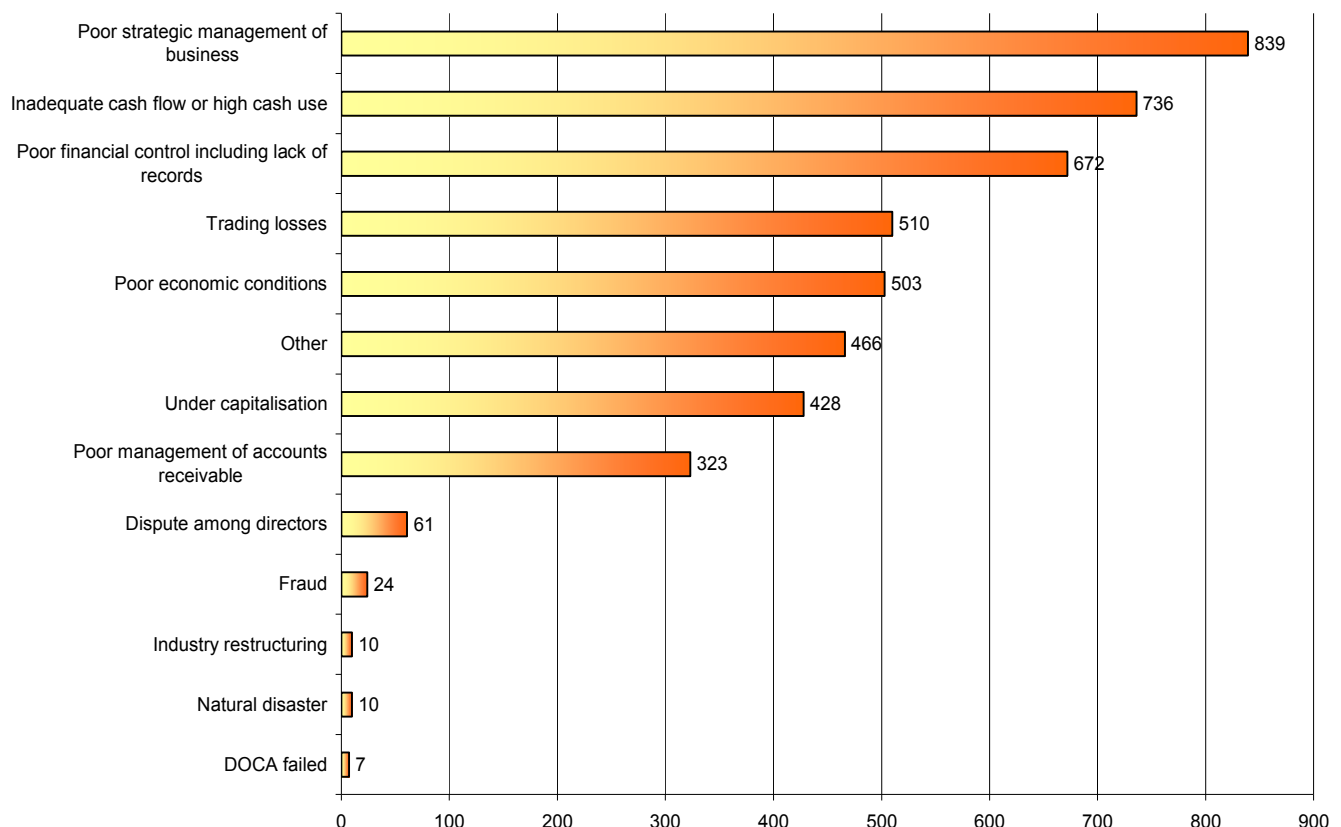
Why did these companies fail ?

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.

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.

Figure 3. Nominated causes of company failure, construction (1 July 2009 – 30 June 2010)



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. Across all industries, it was found that in 68.8% of cases, there was 'Possible Misconduct' reported.

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

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

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

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

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.

Despite the high suspected level of breaches and indeed multiple breaches, in the 12 month period (from 1 July 2009 to 30 June 2010) there were only 211 reports where an external administrator was able to obtain documentary evidence of the breaches and recommended the case warranted further inquiry by ASIC. This was equivalent to 11% of the cases.

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 2009 - 30 June 2010)

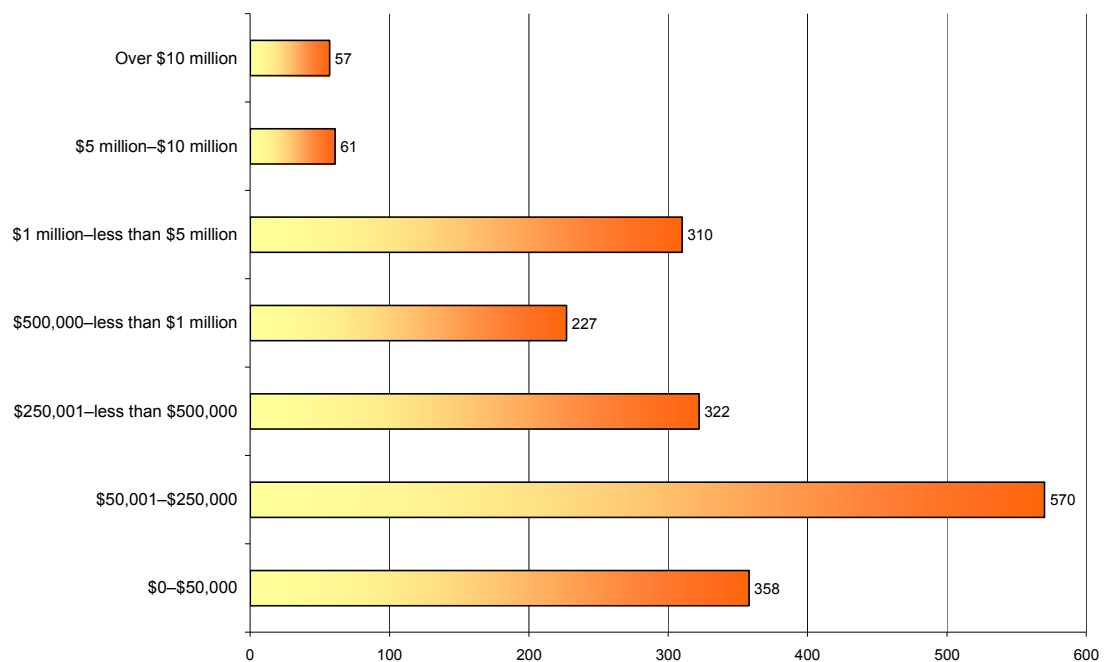


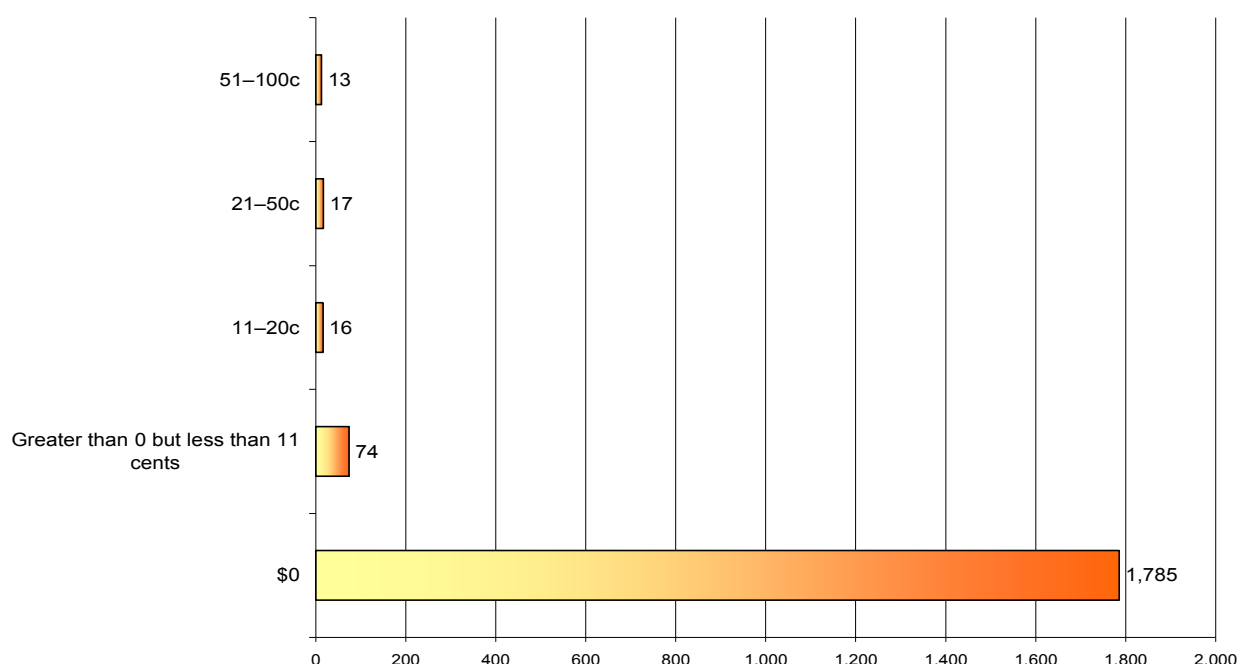
Figure 4 shows the number of companies in the construction sector that had monetary deficiencies (i.e. assets less liabilities) in each value range. Two thirds had a deficiency of less than \$500,000, with 16% having deficiencies of between \$500,000 and \$1 million and 22% had deficiencies of between \$1 million and \$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 **\$2,627,950,000**. It is estimated 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 94% of cases, there is no return to unsecured creditors whatsoever.

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 2009 - 30 June 2010)



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/Insolvencies%2C%20terminations%20%26%20new%20reg%20stats%20portal%20page>

What Kingsway does

Kingsway Financial Assessments provides its clients with access to fast, reliable and independent financial assessment reports to support better decision making.

Our role is to identify companies in financial distress or at risk of insolvency and evaluate tenderers' financial capacity to deliver projects, goods and services.

Kingsway's range of services can help you to:

- Assess tenderers' financial capacity to undertake construction projects,
- Assess the eligibility of contractors for prequalified contractor panels,
- Develop risk management strategies for your supply chain.

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