

Financial problems or insolvency

Information sheet Victorian incorporated associations and companies limited by guarantee

This information sheet provides information for Victorian incorporated associations and companies limited by guarantee that are facing financial difficulties or are concerned about becoming insolvent.

Not-for-profit community organisations face financial difficulties for a number of reasons, and it may be external forces such as economic trends that cause strain on an organisation's financial position. Whatever the cause, organisations and committee members need to be aware of the possibility and consequences of insolvency.

Acting on early warning signs is important!

This information sheet covers:

- ▶ What is insolvency?
- ▶ How can the committee protect against insolvency?
- ▶ Does the committee have a duty to prevent insolvent trading?
- ▶ What are the consequences of breaching duties?
- ▶ What can we do if our organisation is facing insolvency?

Some common terms

Here are a few of the common terms used in this sheet:

- ▶ **ATO:** the Australian Taxation Office
- ▶ **cash flow:** cash receipts minus cash payments over a given period of time; the movement of cash in and out of an organisation over a given period of time
- ▶ **CAV:** Consumer Affairs Victoria

- ▶ **creditor:** a person, company or other organisation that your organisation owes money to (for example, the paid staff are creditors if they are owed wages, the landlord is a creditor if he or she is owed rent)
- ▶ **debtor:** the opposite of a creditor, namely, a person, company or other another organisation that owes money to your organisation (for example, someone your organisation's agreed to provide services to for a fee)
- ▶ **liquidator, receiver, administrator:** people with specialist accounting training who are appointed to investigate and deal with a range of financial issues faced by an organisation. Each has different obligations and priorities - sometimes they will be acting for a creditor and sometimes they will be appointed by the committee or even a court to wind up the organisation, and
- ▶ **winding up:** bringing the organisation to an end or closure, either because of financial problems or because the members agreed, perhaps because the project or mission of the organisation has finished.

What is insolvency?

Deciding if an organisation is insolvent can be complex. It can be difficult to determine the solvency of an organisation simply by looking at its financial records / accounts. A range of factors will be relevant.

Example:

The law provides that an organisation is 'insolvent' if it is unable to pay all its debts when they fall due.

The test is basically a 'cash flow' test: 'does the organisation have access to enough cash (including deposits and loans) and expected future income, to meet its current and expected future expenses'?

This cash flow test is applied, rather than asking whether or not the organisation's assets exceed its liabilities.

The ability to collect money owed to the organisation, to raise funds and sell an organisation's assets (for a reasonable market value in a timely manner), are relevant considerations as to whether an organisation is 'unable to pay its debts when they fall due'.

Insolvency does not arise just because the organisation does not, at a particular point in time, have enough money. The organisation's financial position as a whole must be considered. Any

combination of the following factors can indicate that an organisation is near insolvency or is actually insolvent. None of these factors is decisive, but they should act as a warning to committee members that they should consider taking steps to protect against insolvency:

- ▶ continuing losses over successive financial reporting periods
- ▶ overdue tax debts, for example 'pay-as-you-go' (PAYG) instalments, GST, superannuation guarantee contributions
- ▶ increasing levels of bad or doubtful debts, the collapse of a significant creditor or withdrawal of a major source of funding
- ▶ inability to borrow funds or get loan approvals
- ▶ cheques issued by the organisation being returned dishonoured
- ▶ cheques are being issued post-dated (that is, dated after the date on which it is actually written) or are not being sent
- ▶ delays in paying suppliers resulting in stricter credit terms or suppliers insisting on "cash on delivery"
- ▶ legal proceedings being initiated or threatened by creditors, including the ATO, or judgments being entered against the organisation, and / or
- ▶ repeated failure to produce timely and accurate information on the organisation's financial position.

Get expert help:

If your organisation is experiencing any of the above factors, you need to take action to prevent insolvency or, in a worst case, to prevent the organisation from continuing to operate while insolvent.

You should:

1. speak with the organisation's accountant, discuss the concerns with the organisation's auditor (if any) or find an accountant who can help,
2. if there is any doubt about how to overcome or improve the problems quickly, find a qualified accountant with insolvency experience to assess the overall financial position of the organisation and determine if there is a risk of insolvency.

Having independent, experienced advice can help your organisation work out what is not working, how things can be improved and what action needs to be taken. It can be a very wise use of your organisation's funds!

Tip:

If legal proceedings are threatened or initiated by creditors, including the ATO, you must not ignore them! They can result in a court placing the organisation in the hands of a liquidator. Speak to a lawyer urgently. If in doubt, you can telephone PilchConnect.

What can the committee do?

The main thing a committee can do to protect against insolvency or the consequences of insolvency, is to prevent an organisation from incurring debts when there are reasonable grounds to suspect it will be unable to repay them.

This means committee members must insist that they are kept up-to-date on the financial circumstances of the organisation (ie. its liabilities and cash flow) at all times. This knowledge will enable a committee member to take steps to protect the organisation against insolvency, and in that way act in the organisation's best interests. Those steps may include identifying problem areas and reducing expenses / liabilities or increasing income and cash flow, or at least ensuring that the problem does not get any worse.

Does the committee have a duty to prevent insolvent trading?

Tip:

If you are not sure what your organisation's legal structure is (or even if it is incorporated), check on-line (for free) by entering your organisation's name or ABN at the [Australian Business Register website](#) search and check the 'entity type'.

If your organisation does not appear on this register, then search on the [CAV website](#).

If your organisation does not appear on either of these registers, then it is likely to be unincorporated.

Yes. To understand why, we have set out the law in relation to incorporated associations and companies limited by guarantee separately.

Changes to the law and the not-for-profit sector:

Reforms of the not-for-profit sector in Australia are also underway, including the creation of the Australian Charities and Not-for-Profits Commission (ACNC) which will operate as the national regulator of not-for-profit organisations to provide an independent 'one-stop-shop' national regulator.

The Victorian Government is also changing the laws about incorporated associations. These changes are expected to become law on 1 July 2012.

To keep up to date with these changes, [sign up to PilchConnect's e-bulletin](#) and you'll know when the law changes and how it affects you.

Incorporated associations

The *Associations Incorporation Act* does not expressly prohibit committee members from allowing an association to trade while it is insolvent. However, committee members are often regarded as having similar duties as directors of companies under the *Corporations Act*, and it is generally accepted that the duty to prevent insolvent trading applies to committee members as well as to directors.

It is best practice for committee members to comply with these duties and the Victorian government is likely to change the *Associations Incorporation Act* to expressly include this duty as has been done in some other States.

The three basic directors' duties are:

- ▶ A duty of good faith and loyalty to the organisation. There are several aspects to this duty of good faith and loyalty:
 - ▶ you must act in good faith in the best interests of your organisation, even if this is not in your own best interests
 - ▶ you must act for a proper purpose, and never take advantage of your position as an office bearer or information you have gained in the role for personal advantage, and
 - ▶ you must avoid conflicts of interest between your own personal interests and the interests of the organisation.

- ▶ A duty to exercise reasonable care and skill in carrying out the role of a committee member, and
- ▶ A duty to prevent insolvent trading by the association, which includes the duty not to incur a debt that will cause the association to become insolvent.

Further information on the duties on committee members of incorporated associations can be found on our page on [‘People involved in an incorporated association’](#).

Tip:

Ignorance is no excuse, and the duty applies to all committee members (not just the Treasurer). You must not simply turn a ‘blind eye’ to the financial status of the organisation, or leave the problem to other committee members.

Companies limited by guarantee

Directors of a company limited by guarantee are required by the *Corporations Act* to comply with the duties listed above. This includes the duty to prevent insolvent trading which is expressly stated in the *Corporations Act*.

For further information on the duties on directors of companies limited by guarantee, see our page on [‘People involved in a company limited by guarantee’](#).

What are the consequences of breaching this duty?

Incorporated associations

The *Associations Incorporation Act* states that, as a general principle, the members of an association (including committee members and the Public Officer) will not be personally liable for the debts of an association, or for the expenses involved with the winding up.

However, the situation in relation to breaching these (director-like) duties, such as insolvent trading is different. A committee member may be personally liable for the debts of an association where they have failed to meet the duty to act in the association’s best interests and prevent insolvent trading.

If a liquidator is appointed to an association, it is possible for the liquidator to consider a claim against any or all of the committee members alleging breach of their duties. However, there would

need to be clear evidence of a breach, such as an obvious failure to act in the association's best interests.

Further information on the duties of committee members of an incorporated association can be found on our page on ['People involved in an incorporated association'](#).

Companies limited by guarantee

Directors of companies limited by guarantee may be personally liable for debts of the company where they have knowingly allowed the company to trade and incur debts while it is insolvent.

There are significant civil (and in some cases criminal) penalties that can apply to directors that fail to meet the expected standard of care, and directors should always ensure that they:

- ▶ act honestly and diligently and in compliance with the company's constitution,
- ▶ act in the best interests of the company;
- ▶ never use their position for personal advantage (or for the benefit of a friend or associate);
- ▶ always disclose conflicts of interests; and
- ▶ not allow the company to trade while insolvent.

Further information on the duties of a director of a company limited by guarantee can be found on our page on ['People involved in a company limited by guarantee'](#).

What should we do if our organisation is facing insolvency?

If you are concerned that your organisation is nearing insolvency, speak with the organisation's accountant and auditor or if the organisation doesn't have one, then organise a qualified accountant with insolvency experience to look at the overall financial position of the organisation. You may need an insolvency expert even if you have an accountant or auditor.

You should consider whether to:

- ▶ negotiate a payment plan with the ATO if there are outstanding tax or superannuation guarantee contribution debts
- ▶ negotiate a payment plan with creditors including banks
- ▶ call in any outstanding debts or fees owed to the organisation

- ▶ seek financial assistance from members
- ▶ seek financial assistance from the community
- ▶ review options for cost cutting, including reducing employee costs
- ▶ approach banks or other lenders for a loan (providing the organisation will in the future have income sufficient to make repayments as and when they fall due), and / or
- ▶ investigate alternative sources of income, such as fee-for-service income.

Sometimes a public fundraising drive is a good option. Community organisations can often rely on the broader community to provide support in times of need, and it may be an option to initiate a funding drive amongst members and external supporters of the organisation. However, you should not rely on this approach as a means of fixing your financial issues. The causes of the problems should be identified and fixed well before they become a significant problem.

Our web portal has a page dedicated to [fundraising](#), which provides further guidance on the steps needed to consider before your organisation undertakes a public fundraising campaign. It may be necessary for your organisation to register as a fundraiser with CAV.

However, if you suspect that your organisation is facing insolvency or already insolvent and none of the options above is likely to produce a quick turnaround, more drastic action may be required in the interests of the organisation, its creditors and members.

An independent qualified accountant with insolvency experience who has looked at the financial position of the organisation will be best placed to advise you on your options, which may include appointing a liquidator or other external insolvency administrator.

Tip:

Acting early and getting expert advice can be the difference between your organisation becoming insolvent, or not.

How can our organisation find an insolvency expert?

To find a qualified accountant, auditor or accountant with insolvency experience, there are three peak bodies for accounting professionals and one specifically for insolvency practitioners: [CPA Australia](#), [The Institute of Chartered Accountants](#), [National Institute of Accountants](#) or [Insolvency Practitioners Association](#).

Ask for a recommendation of a person or firm that has experience in dealing with not-for-profit groups and ask for a guide as to the fees that are likely to be charged, (if your organisation is small / volunteer run you can try to negotiate with the particular practitioner for a reduced fee).

How can our organisation find a lawyer with insolvency expertise?

To find a lawyer who has experience in insolvency law (eg. if a creditor has issued legal proceedings against your organisation), search through the Law Institute Victoria's (LIV) [Legal Referral Service](#).

All law firms included in the legal referral service will provide a 30 minute enquiry interview free of charge. If you request the solicitor to undertake any legal work on your behalf (eg. reading contracts, writing letters etc) the solicitor's normal fees will apply. Make sure you discuss costs before any work is undertaken. The Legal Referral telephone service operates 9am to 5pm Monday to Friday. Please call 03 9607 9550. Online access is available 24 hours a day via the LIV website.

How can PilchConnect help our organisation?

If you are involved in a Victorian not-for-profit community organisation, and your organisation has a legal issue, PilchConnect may be able to provide free assistance, via its telephone advice service or legal referral service (see [Resources](#) at the end of this document).

Resources

PILCHConnect resources

- ▶ [Guide: Duties of committee members in Victorian incorporated associations](#)
- ▶ [Fundraising](#)
- ▶ [The people involved in an incorporated association](#)
- ▶ [The people involved in a company limited by guarantee](#)
- ▶ [Unincorporated associations and the incorporation decision](#)

Other PilchConnect services

- ▶ [Legal advice](#)

Legislation

Associations Incorporation Act 1981 (Vic)

Associations Incorporation Regulations 1998 (Vic)

Corporations Act 2001 (Cth)