3.6 Efficiency ratio analysis (HL)

Insolvency versus bankruptcy

The terms insolvency and bankruptcy are often confused. A business that is insolvent is not necessarily bankrupt. However, a business that is bankrupt is insolvent.

Insolvency

Insolvency is a situation where an individual or a business is not able to pay its debts. As you have learned earlier in this course, a lack of finance is the leading cause of business failure. In Subtopic 3.5 (/study/app/y12-business-management-a-hl-may-2024/sid-351-cid-174702/book/the-big-picture-id-39042), you were also introduced to the working capital cycle, which outlines the flow of funds out of the business to purchase resources and the flow of cash back into the business as consumers purchase products. When this working capital cycle does not function effectively, a business can become insolvent.

Figure 1. Insolvency means that a business cannot pay its debts.

Credit: Isabel Pavia, Getty Images

Insolvency can occur under the following conditions:

- **Debtor days are too long**. Customers take a long time to pay for products, which reduces the cash flow into the business.
- **Loss of sales revenue**. This can occur due to internal factors, such as poor-quality products or high labour turnover, or external factors, such as increased competition or poor economic conditions.
- **Increased costs**. This can occur due to internal factors, such as inefficient production and waste, or external factors, such as increased competition for resources, inflation or rising interest rates.
- **Legal action**. If the business is sued, it may be forced to pay high legal fees or even settlements.

Bankruptcy

When a business cannot pay its debts, it may need to file for bankruptcy. Bankruptcy is a legal process that may give an insolvent business a chance to restructure its operations and debt, so that it may become profitable again. In some common law countries – such as the UK and Australia – the term 'bankruptcy' is used only for individuals and businesses with unlimited liability, such as sole traders and partnerships. For businesses with limited liability in those countries, the term 'going into administration' is used for this legal process.

Sometimes a business, particularly a smaller business such as a sole trader or a partnership, will need to liquidate current and non-current assets immediately to pay creditors all or part of the debts owed. Larger limited liability companies who declare bankruptcy, or go into administration, may develop a plan to become solvent again. For a time, the business will be protected from creditors. This plan will be monitored by an authority. If the plan does not work, then the business's assets may be liquidated to pay debts. Liquidation is usually the last resort for an insolvent business because of the significant impact that the business failure may have on a wide range of stakeholders.

Regardless of the outcome, bankruptcy will significantly damage the business reputation of those owners and managers involved. It is important, therefore, that businesses keep a close eye on their working capital to avoid insolvency in the first place. This can be done through careful and ethical accounting practices and avoiding large debts and risks.

Figure 2. Small businesses in bankruptcy may need to close and liquidate their assets to pay creditors.

Credit: Nathan Bilow, Getty Images

Activity

Learner profile: Inquirer
Approaches to learning: Research (information literacy)

Bankruptcies during the COVID-19 pandemic

Small- and medium-sized enterprises (SMEs) are defined as companies that have less than 250 employees. According to the IMF, 99.8% of all companies are SMEs. SMEs employ 65% of private sector workers and account for more than half of all private sector output. SMEs were particularly vulnerable to the external shock of the COVID-19 pandemic. In other circumstances, SMEs could manage short-term funding needs with short-term loans. But the length of disruption during the pandemic meant that many businesses could not survive their revenue declines. As a result, the rate of bankruptcy, where companies legally declare that they cannot repay debts, increased during the pandemic.

The data in **Table 1** comes from an early IMF working paper in September 2020, where researchers estimated yearly bankruptcy rates (without government support) that would be caused by the COVID-19 pandemic in different sectors. The estimates were made for some countries in the Organisation for Economic Cooperation and Development (OECD), a group of high-income countries.

Table 1. Estimated bankruptcy rates by sector caused by the COVID-19 pandemic (2020).

Source: IMF Working Paper WP/20/207 (https://www.imf.org/-/media/Files/Publications/WP/2020/English/wpiea2020207-print-pdf.ashx)

	Non-COVID bankruptcy rates (%)	COVID-19 bankruptcy rates (%)	Change
Agriculture	9.44	13.52	4.08
Mining	12.50	36.03	23.54
Manufacturing	8.48	16.73	8.25
Electric, gas and air con	9.35	11.31	1.96
Water and waste	6.72	9.65	2.93
Construction	7.97	10.19	2.21
Wholesale and retail	9.12	18.21	9.10
Transport and storage	7.64	13.28	5.63
Accommodation and food service	13.15	38.59	25.44
Info and comms	10.00	15.92	5.92
Real estate	11.61	17.38	5.76
Prof, Sci and Technical	10.24	18.85	8.60

	Non-COVID bankruptcy rates (%)	COVID-19 bankruptcy rates (%)	Change
Administration	8.32	19.39	11.06
Education	10.86	30.04	19.18
Health and social work	7.74	11.22	3.48
Arts, entertainment and recreation	12.95	36.55	23.60
Other services	12.80	31.42	18.62

Questions

1. State the percentage of bankruptcies estimated in normal conditions in the Education and Health and Social Work sectors. [2 marks]
2. Outline how the percentage of bankruptcies in the Manufacturing sector was estimated to change from normal to COVID-19 conditions. [2 marks]
3. Identify which sector was estimated to have the largest change in bankruptcies due to the COVID-19 pandemic and explain why. [4 marks]