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The impact of the pandemic on the solvency of corporations, third quarter 2020

by **Alexandre Fortier-Labonté**

This article provides disaggregated data to better understand the impact of COVID-19 on specific groups. Visit the Gender, Diversity and Inclusion Statistics Hub for more analysis, including disaggregated data on labour, public safety, health and more.

The COVID-19 pandemic has posed significant challenges to the Canadian economy and the financial position of enterprises. The second quarter of 2020 saw the steepest decline in real gross domestic product (-11.3%) since quarterly data were first collected in 1961. Over the same period, enterprises reported lower net income before taxes (-8.6%) and operating revenues (-13.1%), according to the Quarterly Survey of Financial Statements (QSFS).

This article examines the changes in the number of companies that filed under the *Bankruptcy and Insolvency Act* and the *Corporations' Creditors Arrangement Act* from 2006 to the third quarter of 2020. The analysis highlights the number of firms filing for creditor protection, as well as the financial position of these firms before the onset of the pandemic.

The *Bankruptcy and Insolvency Act* (BIA) regulates the law on bankruptcy and insolvency in Canada. It governs bankruptcies, consumer and commercial proposals and receiverships in Canada. The Office of the Superintendent of Bankruptcy is responsible for ensuring that bankruptcies are administered in a fair and orderly manner.

Corporations filing under the BIA are not necessarily declaring bankruptcy. They can file a proposal under the Act, which can lead to restructurating their debt if an agreement is reached with its creditors. When no agreement can be reached between a corporation and its creditors, a bankruptcy procedure is undertaken. A bankruptcy under the BIA is designed to provide financial relief to corporations with overwhelming debt burdens, halting the legal actions of creditors[1].

The *Bankruptcy and Insolvency Act* is not the only law that regulates bankruptcies in Canada. There is also the *Companies' Creditors Arrangement Act* (CCAA), which allows financially troubled corporations to restructure their affairs. The CCAA is restricted to larger corporations, as they must owe creditors in excess of $5 million to be eligible under the Act.

The scope of this article looks at insolvency fillings under both Acts; the BIA and CCAA. For the purpose of this study, there is no distinction made between a corporation filing for bankruptcy or a proposal; they are both treated as insolvencies.

Historically, insolvency filings increase during economic downturns

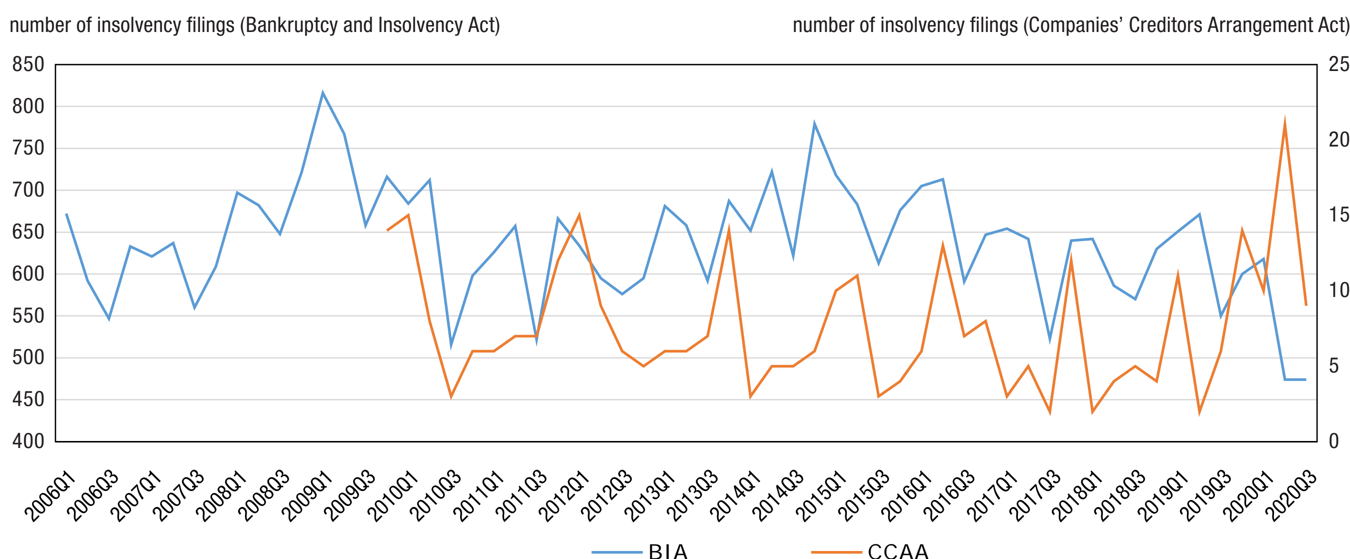
The financial crisis of 2008[2] had an immediate impact on the number of fillings made under the BIA in Canada. BIA fillings rose 11.3% from the third quarter of 2008 to 721 in the fourth quarter and reached a record high of 816 in the first quarter of 2009.

1. There are a number of corporations who goe out of business without filing for bankruptcy. They liquidate their assets and cease operations.
2. The financial crisis culminated by the bankruptcy of Lehman Brothers in September 2008. Canada was in a recession from the fourth quarter of 2008 to the second quarter of 2009.

The 2014 oil crash also had a major economic impact on the Canadian economy. Oil prices (Western Canadian Select) fell from $US83 in July 2014 to $US37 in February 2015, which seriously affected businesses in the oil and gas extraction and support activities industry. This was reflected in the number of BIA fillings, which increased by one-quarter (+25.2%) from the third quarter to reach 779 in the fourth quarter of 2014.

The numbers of CCAA filings (large companies) also increased over this period[3]. Filings over doubled from 5 in the third quarter of 2014 to 11 in the second quarter of 2015, when 3 corporations in the oil and gas extraction and support activities industry filed for insolvency.

Chart 1
Number of insolvency filings under the Bankruptcy and Insolvency Act and the Companies' Creditors Arrangement Act, 2006 Q1 to 2020 Q3, unadjusted data



Source: Office of the Superintendent of Bankruptcy of Canada, author's calculations.

BIA insolvency filings decline since the beginning of the pandemic, while CCAA filings increase

The number of BIA filings fell by almost one-quarter (-23.3%) from the first quarter of 2020 to 474 in the the second quarter (Chart 1) and was down by 29.4% compared with the same quarter a year earlier. In the third quarter of 2020, the number of fillings was unchanged at 474 and 13.8% lower year over year.

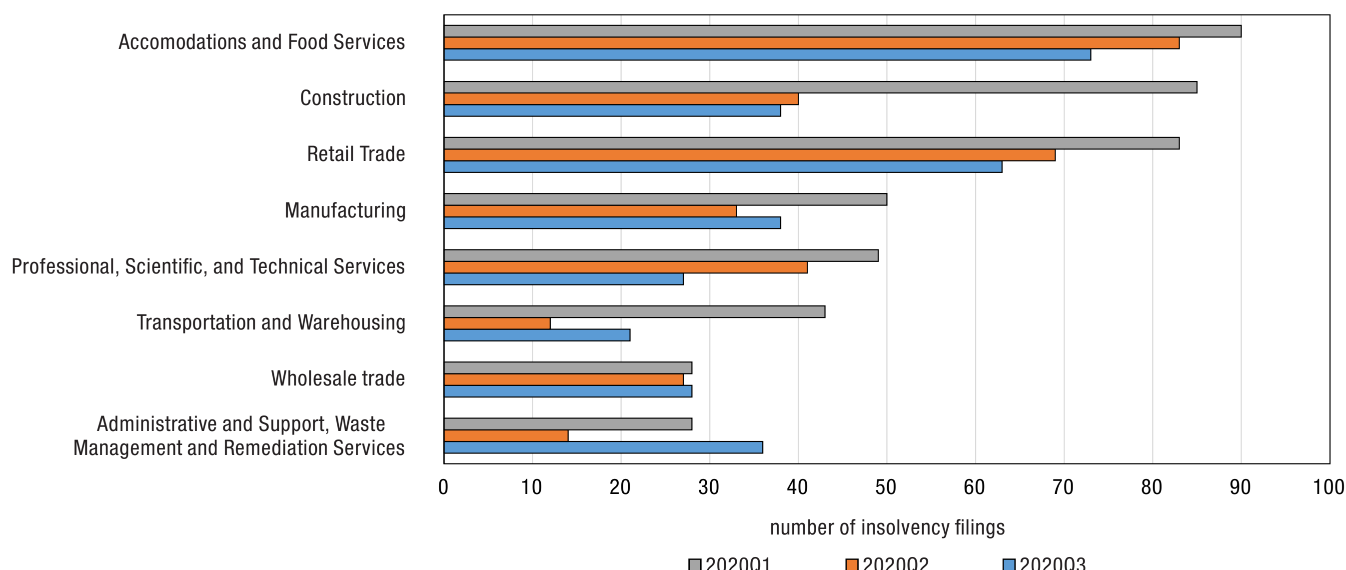
This decline in insolvencies during the COVID-19 crisis could partially be explained by the government programs[4] to support businesses and help them stay afloat during this difficult period. This could suggests that corporations are waiting to see if more government aid is coming, before filing for insolvency. Low borrowing cost for businesses[5] could also partially explain this drop in insolvency filings.

3. As of September 18, 2009, CCAA filing records have been kept in the OSB Public Registry. The OSB does not have information about CCAA proceedings prior to this date.
4. The following support programs were established: the Canada Emergency Business Account, the Canada Emergency Wage Subsidy and the Canada Emergency Rent Subsidy. As of the end of November 2020, there were approximately $49.3 billion of subsidies paid to businesses through the Canada emergency wage subsidy.
5. The Bank of Canada decreased their key policy rate to 0.25% in March 2020 . They have also undertaken quantitive easing since the start of the pandemic, to influence the longer-term interest rates.

Insolvency filings were down in most industries (Chart 2) in the second quarter, led by the construction industry (-32.1% or -45). The construction industry had the largest number (14.1%) of loan approvals among industries in April and May through the Canada Emergency Business Account (CEBA)[6], according to the Survey of the Canada Emergency Business Account.

Conversely, CCAA's insolvency filings doubled from 10 in the first quarter to 21 in the second quarter. This was an historic high for the number of CCAA's fillings. The increase was led by corporations in the manufacturing (+3) and the oil and gas extraction and support activities industry (+2). There were 9 filings in the third quarter.

Chart 2
Number of Bankruptcy and Insolvency Act insolvency filings, selected industries



Source: Office of the Superintendent of Bankruptcy of Canada, author's calculations.

Corporations filing for insolvency under the BIA were below their industry's average in terms of financial position before the pandemic hit

This section focuses on industries where the majority of corporations filed for insolvency up to the third quarter of 2020. It will focus on two measures, namely the quick ratio and debt-to-equity ratio. These ratios shed light on a corporation's liquidity situation. They are a class of financial indicators that reflect a corporation's ability to meet their debt obligations.

The quick ratio measures a corporation's ability to meet its short-term obligations with its most liquid assets (current assets excluding inventories). The higher the ratio, the better the corporation's liquidity position.

$$\text{Quick Ratio} = \frac{\text{Current Assets - Inventories}}{\text{Current Liabilities}}$$

6. CEBA was designed to provide zero interest, partially forgivable loans to small and medium businesses to help finance expenses that could not be avoided or deferred as they took steps to safely navigate the shutdown this spring, thereby helping to position them for a successful relaunch when the economy reopened.

The debt-to-equity ratio measures how much equity and debt a company is using to finance its assets. It is used as a proxy for the extent to which shareholder's equity can fulfill obligations to creditors in the event of a loss of business. A low debt-to-equity ratio indicates a lower amount of financing by debt via lenders, versus funding through equity. A higher ratio indicates the company is getting more of its financing by borrowing money, which subjects the company to potential risk if debt levels are too high.

$$\text{Debt-to-Equity Ratio} = \frac{\text{Borrowings} + \text{Loans and Accounts with Affiliates}}{\text{Total Equity}}$$

Although these ratios are helpful to understand the financial position of a corporation, they cannot provide a complete picture of a company's solvency. Rather than being exhaustive, this analysis aims at providing an indication of the financial health of these corporations a year or less before filing for insolvency, in the context of the pandemic.

Table 1 shows the average quick and debt-to-equity ratios for corporations that filled under the BIA during the first three quarters of 2020. The metrics are computed using the financial statements from 2019[7]. They are compared with the quick ratio and debt-to-equity ratio published in the QSFS[8].

To make appropriate comparisons, it is necessary to compare the financial metrics of a corporation with those in the same industry. Each industry has its own sets of specificities and constraints, which impact its financial metrics and financial composition[9].

The quick ratio for corporations filing under the BIA was below their industry averages during the first three quarters of 2020. These corporations had less cash and other liquid assets (such as marketable securities and stocks) to cover their current liabilities compared with their respective industry averages. The BIA firms, therefore, indicated a potential solvency risk in the period leading up to the onset of the pandemic.

For instance, in the second quarter, the quick ratio for corporations filing under the BIA in the wholesale industry was 0.45 compared with the industry-wide average of 1.13, according to the QSFS. In other words, for every $1 of current liability, the corporations that filed for insolvency had $0.45 of liquid assets, compared with the wholesale industry average of $1.13.

A negative debt-to-equity ratio stems from the negative equity position of a corporation, which implies that the corporation has more liabilities than assets. A negative equity position is generally not common, but in the context of a corporation filing for insolvency, it is understandable to observe this phenomena. Therefore, in the context of this analysis, a negative debt-to-equity ratio can be regarded as a high debt-to-equity ratio.

Table 1 shows the debt-to-equity ratios of corporations that filed for insolvency were significantly higher than their industry's average, which suggests they relied more heavily on debt financing and were less able to absorb a negative shock to the economy. These corporations were therefore more susceptible of becoming insolvent.

7. The data set on corporations' insolvency fillings was linked to T2 financial information. Corporations' 2019 tax filings was added, giving a snapshot of its financial position and performance a year or less before filing for insolvency.
8. The data collected by the QSFS program comprises financial statements prepared by incorporated businesses to record their financial position and performance.
9. Capital-intensive industries such as construction have a higher debt-to-equity ratio, as they require large amounts of investment in fixed capital. On the other hand, industries such as professional and technical services are more labour-intensive and require less debt or capital investment to generate revenues, and hence, have a lower debt-to-equity ratio.

Table 1
Financial ratios for selected industries

Industry	Quarter	2019 BIA quick ratio	2019 QFS quick ratio	2019 BIA debt to equity ratio	2019 QFS debt to equity ratio
Construction	2020Q1	0.79	1.05	-1.79	1.56
	2020Q2	0.96	1.06	3.54	1.55
	2020Q3	0.46	1.06	-0.19	1.51
Manufacturing	2020Q1	0.33	0.95	-0.43	0.69
	2020Q2	0.52	0.97	-0.22	0.66
	2020Q3	0.28	0.97	-0.26	0.67
Wholesale	2020Q1	0.09	1.12	0.73	0.82
	2020Q2	0.45	1.13	1.75	0.81
	2020Q3	0.65	1.15	-1.69	0.81
Retail	2020Q1	0.28	0.61	-1.03	1.10
	2020Q2	0.35	0.60	-3.39	1.10
	2020Q3	0.44	0.62	0.67	1.12
Art, Entertainment and Recreation	2020Q1	0.28	0.98	-0.01	1.63
	2020Q2	0.48	0.96	2.22	1.64
	2020Q3	0.19	1.00	-0.05	1.56
Professional and Technical Services	2020Q1	1.02	1.79	4.75	0.59
	2020Q2	0.38	1.81	-0.25	0.58
	2020Q3	0.21	1.82	-0.49	0.57

Source: Statistics Canada, author's calculations based on data from T2 information return & Quarterly Survey of Financial Statements

Overall, both the quick and debt-to-equity ratios from the selected industries show that corporations filing for insolvency mostly underperformed compared with their industry averages. This suggests that these firms faced some challenges in both short-term liquidity and financial leverage that lead them to file under the BIA, in spite of the COVID-19 crisis.

Corporations filing for insolvency are likely to increase in the coming quarters

These results also suggests that corporations that filed for bankruptcy in 2020 were already in a precarious financial situation before the COVID-19 crisis hit. Even with the help of government programs, these corporations decided to file for insolvency.

However, the fact that the number of corporation filings has decreased since the onset of the pandemic could indicate that businesses are waiting to see if more government aid will be forthcoming, and wether they will be able to manage their debt levels, before filing for insolvency.

According to the Canadian Survey on Business Conditions, 43.9% of businesses reported that they were unable to take on more debt in the third quarter of 2020. This suggests that there might be more insolvency filings in coming quarters as the financial position of businesses deteriotates.

Statistics Canada will keep tracking corporations' insolvency fillings in the coming quarters, as the impact of the COVID-19 crisis continues to disrupt the normal activities of Canadian corporations.