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Dick Smith directors liable for dividends, bad stock: receivers

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HIGHLIGHT: Former directors of Dick Smith are liable to compensate the retailer for $28 million in dividends that should never have been paid and $189 million in bad stock, receivers claim.

Former directors of Dick Smith Electronics received more than $2 million in tax-free cash in 2015 after declaring dividends that should never have been paid.

Those directors are now liable to compensate Dick Smith for not only the fully-franked dividends they received on their shares but the entire $28.3 million the company paid in distributions in 2015 as well as about $189 million in bad stock that accumulated as a result of the company's rebate-driven buying strategy.

Fourteen months after Dick Smith collapsed owing $400 million to creditors, the retailer's receivers are suing eight former directors and ten of its insurers after alleging that directors breached their duties by:

- pursuing a strategy driven by rebates rather than customer demand,
- failing to put in place any adequate procedures, practices or systems to monitor the purchase and impairment of inventory,
- and failing to ensure the financial statements of DSH properly accounted for inventory and rebates in accordance with Australian Accounting Standards.

As a result of these failures, Dick Smith acquired and accumulated about $189 million in bad stock, published financial results for which there was no proper basis and paid dividends in 2015 which should not have been paid at all or which should have been substantially lower.

The allegations are laid out in a statement of claim lodged in the NSW Supreme Court on Friday by Dick Smith's receivers, James Stewart, Jim Sarantinos and Ryan Eagle from Ferrier Hodgson.

The receivers are suing directors and insurers, through the company's $150 million directors and officers insurance policy, to recover the overpaid interim and final dividends and losses arising from bad stock.

The eight former directors are chief executive Nicholas Abboud, chairmen Phil Cave, from Anchorage Capital Partners, and Robert Murray, finance director Michael Potts, and non-executive directors Bill Wavish, Lorna Raine, Robert Ishak and Jamie Tomlinson.

The insurers include Allianz Australia, QBE Insurance (Europe), AIG Australia, ACE Insurance, Liberty Mutual and Navigators Insurance Underwriting.

According to the statement of claim, Dick Smith adopted a strategy of maximising rebates from suppliers by at least May 2014, six months after its $520 million initial public offer in December 2013.

From as early as December 2014 the group engaged in a practice of uplifting invoices, particularly for private label stock, which involved cancelling previous invoices for stock that had been issued without rebates and asking suppliers to issue new invoices showing rebates and an equivalent increase in the cost of the goods.
From at least July 2014, certain types of rebates, including over and aboves, were recognised in the accounts immediately after being negotiated with suppliers - before the rebates were received and before the stock had been paid for or sold - breaching Australian accounting standards.

The aim of this practice was to increase gross profit, earnings before interest, tax, depreciation and amortisation and net profit.

"At all material times, Dick Smith did not have in place or implement any adequate procedures, practices or systems to detect, value or (where necessary) provision for or write-off obsolete or near end of life inventory, or perform stock takes," the statement of claim said.

By February 2014, as like-for-like sales declined and cashflow became constrained, Dick Smith needed to seek extensions of finance facilities with Westpac and Macquarie Bank. It was also forced to ask certain suppliers to defer delivery of goods or to extend payments because it had insufficient funds to pay.

And yet on February 12 2015, Dick Smith's directors - who at that stage included Mr Cave, Mr Wavish, Mr Potts, Mr Abboud, Ms Raine and Mr Ishak - passed a resolution that Dick Smith pay a 7?? a share interim dividend.
In order to pay the $16.6 million dividend the company had to extend an overdraft facility.

The statement of claim says there was "no proper or adequate basis" to approve the interim accounts or declare the dividend.

Over the next five months Dick Smith's cashflows deteriorated and stock levels continued to build, but no provisions or writeoffs were made.

The company was forced to exceed and extend its finance facilities with Westpac and Macquarie, failed to pay certain suppliers such as Samsung on time, and was forced to borrow new funds on better terms from National Australia Bank and HSBC, using some of the funds to repay Westpac.

Despite the company's increasingly precarious situation, on August 17 2015 directors - who at this stage included Mr Abboud, Mr Potts, Mr Murray, Mr Tomlinson, Ms Raine and Mr Ishak - approved a resolution to adopt the full-year accounts and pay a 5?? a share final dividend.

According to the statement of claim, "there was no proper or adequate basis for the DSH directors to approve the 2015 full year financial report and form the view that the 2015 full year financial report (a) gave a true and fair view of the financial position and performance of DSH and the DSE Group; (b) complied with the Corporations Act; (c) complied with Australian Accounting Standards."

Dick Smith paid the $11.8 million dividend in September 2015 and the following month was forced to seek a short term $20 million increase in its loan facility.

Later that month directors were told by external consultants that more than one third of Dick Smith's current inventory was bad stock, which exceeded $100 million and was rising rapidly.

By November 13 the value of bad stock had risen to $152 million, representing 44 per cent of total inventory, and by November 23 it had reached $189 million or 56 per cent of inventory, prompting Dick Smith to book non-cash impairment charges of $60 million.

In the first week of December 2015 month directors asked management to develop and implement plans to reduce range and manage inventory by about $100 million to $200 million over the next six months and sought further extensions to a loan facility from HSBC.

One week later Mr Potts told directors the company had lost $3.8 million in the year to date.

By December 29 directors had called in McGrathNicol to advise on the company's cash flows and solvency and by January 4 directors had placed the company into voluntary administration.

Some of the former directors have denounced the receiver's claims as "weak, fallacious, malicious and ludicrous." "For a business to go from issuing a prospectus and several annual reports and profits, to say it doesn't have ANY adequate systems and controls is a real stretch," said one of the former directors, who declined to be named.

Directors have also pointed out that auditor Deloitte undertook extensive testing of rebates and gave the board written assurances that it concurred with management's treatment of rebates and that Dick Smith's reporting of rebate income complied with Australian Accounting Standards.

Deloitte has not been named in the claim. The firm has previously said it stands by its audit of Dick Smith.

Directors also pointed out the statement of claim only covered the actions of directors, not the banks.

They claim Dick Smith failed because the banks exercised their leverage over the business and tried unsuccessfully to prevent Dick Smith making payments on an approved trade credit facility provided by Macquarie Bank.

In a statement, Mr Murray, Mr Tomlinson, Ms Raine and Mr Ishak strongly denied any wrongdoing and said they would defend the action.

"In broad terms, the receivers claim that the non-executive directors breached their duty of care to Dick Smith by failing to put in place adequate systems in relation to rebates and inventory management," the statement said. "The directors acted at all times conscientiously and with care and diligence in undertaking their duties as non-executive directors of Dick Smith."

Directors have previously claimed that if the receivers had decided to honour about $2 million in gift cards after Dick Smith went into administration, sales would not have fallen off a cliff in January and February and a buyer for the whole business could have been found. For example, computer hardware distributor Dicker Data had made a confidential non-binding offer for the company before it collapsed.

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