ACCOUNTING NETWORK

Newsletter

FTI CONSULTING

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Contents

We are pleased to provide you with the latest edition of our *Accounting Network* newsletter.

We thought we would start the new financial year with some tips on how to spot a business that might be in distress, some observations and reminders about the ATO's debt collection initiatives and director penalty notices, and we provide an overview on how to close a solvent company.

While the latest insolvency statistics show that 2014 continues to record the lowest number of insolvencies for the start of a year since 2008, our clients and contacts continue to report mixed views on how businesses are fairing generally.

We've observed for a while now that traditional lenders are looking for business, but are still somewhat cautious, focussing on the fundamentals when assessing new business. This includes strong management and operations, quality information systems and strong operating cash flows.

With this in mind, we thought we'd go through the signs and indicators that can help you recognise a business in some kind of distress.

What are some of the warning signs of a business in distress?

The primary benefit from identifying warning signs is the ability to help your clients address issues early, before it's too late.

The first thing to note is that you won't get all the answers just by looking at the numbers — in fact, we'd argue that you should be looking for largely non-financial information in the first instance to help diagnose a distressed business.

The reason for this is simple: the financial results of a business are the outcomes of earlier decisions and actions taken by its management. They are historical. The financials may well tell a story, but it's a story about the past and could have been several months ago (or more) depending on how timely the financials are prepared. We generally label these financial observations/outcomes as "lag" indicators.

Lead indicators

"Lead" indicators on the other hand are typically non-financial in nature. We are looking for events and data that will impact performance, but before they hit the balance sheet. They include the following items:

- loss of customers, key contracts or staff

About FTI Consulting

FTI Consulting, Inc. is a global business advisory firm dedicated to helping organisations protect and enhance enterprise value in an increasingly complex legal, regulatory and economic environment. FTI Consulting professionals, who are located in all major business centers throughout the world, work closely with clients to anticipate, illuminate and overcome complex business challenges in areas such as investigations, litigation, mergers and acquisitions, regulatory issues, reputation management and restructuring. More information can be found at www.fticonsulting.com.

- government and similar regulatory framework changes
- senior management resigning/retiring suddenly
- management can't communicate their strategy clearly
- business plan lacks objectivity/realistic action items
- an unnecessarily complex business structure or operating model
- poor relationship/communication with key financiers no focus on innovation (old products and solutions)
- a history of poor budgeting and missing forecasts
- frequent changes to directors and/or board members
- Disputes and general disharmony (directors or owners)

Lag indicators

What are some of the lag indicators? They include:

- trading losses
- profit downgrades
- overdue taxation lodgements and payments
- sudden changes in strategy ('turnaround' or 'restructure')
- poor working capital position
- suppliers demanding COD terms
- urgent requests for higher overdraft limits
- looking for a new bank to refinance existing loans
- lenders insisting upon reviews or appointing their own 'consultants' to do these

There isn't a hard and fast rule as to how many warning signs you need to see before that equates to a business destined for insolvency.

The real power from identifying warning signs lies in the ability to ask questions and help clients address issues early on. Early intervention really is the key. More time brings with it more options to deal with/resolve the issues at hand. If you are seeing multiple lag indicators, there are probably some solvency concerns.

Unfortunately, more often than not, we are approached for assistance late in the day when few options remain. Our experience is that business owners are often not proactive in seeking help for one reason or another. This places more reliance on accountants and advisors to help identify possible concerns and then talk to their clients about those concerns.

ATO strategies to reduce $3bn of aged tax debt and defaulted payment arrangements

The ATO continues its efforts to be more proactive on debt collection. They are also looking at ways to better understand the drivers of tax debts.

There were some interesting messages from the ATO Tax Practitioner Advisory Group meeting held in May this year on the subject of 'Debt'. We've reproduced some of those published messages:

> *"The ATO is developing strategies to reduce tax debt and defaulted payment arrangements. Research has commenced to understand the drivers behind accumulation of small business tax debt which is more than two years old (aged debt), and assess the effectiveness of sanctions on the prevention, management and reduction of small business tax debt. At the end of the 2013 financial year small business aged debt totalled over $3 billion of collectable debt. The research will be used in the design of future strategies aimed at reducing and preventing debt.*
>
> *The ATO is developing a pilot to inform taxpayers of the collection actions which may be taken to recover their tax debt as well as the sequence and timeframes of those actions. The ATO aims to highlight to taxpayers the consequence of not dealing with their tax debts in both the early stages and after significant effort from the ATO to collect the debt or enter into payment arrangements. The pilot results will be compared to current strategies to evaluate their effectiveness."*

This behavioural-type research/approach is also happening in other parts of Government, and we think it's a sensible thing for them to be doing. ASIC for example, has engaged a university business school to conduct behavioural research into approaches that can be used to improve director co-operation with liquidators and director compliance with their statutory and other obligations.

What also resonates with us is that the ATO is continuing its efforts to be more proactive and willing to take enforcement steps, compared to a number of years ago. We also see this via higher numbers of insolvency appointments being initiated by the ATO and also a willingness to issue garnishee notices to banks and to the debtors of a business.

Even so, the ATO still seems to lag behind other creditors in how quickly they react — the unpaid tax debts in insolvency appointments are typically considerable (and on many occasions the ATO is the largest creditor). As the ATO continues to refine its strategies, this is something that may start to noticeably change over time.

The ATO and Director Penalty Notices

We are still hearing about instances where director penalty notices are being ignored and bankruptcy happening. This is a risky strategy given that personal liability for directors can now arise automatically.

When companies experience cash flow difficulties, we often see that payments to the ATO are the first to be withheld. This can be a risky strategy as not only is the ATO now more proactive in pursuing outstanding debts (relative to historical practice), but personal liability for directors can arise.

As a starting place, for those struggling to meet their tax payment obligations, the ATO will generally consider requests for companies to pay overdue tax liabilities by way of instalments. This provides the Commissioner with an alternative to commencing recovery action.

In seeking an instalment arrangement, a company must demonstrate that its debts can be fully satisfied at some time in the future and its financial position will improve. It rests with the company to satisfy the Commissioner of this, otherwise an arrangement will not be accepted.

Directors can incur penalties equal to their company's unremitted PAYG withholding liabilities or SGC or unpaid estimates of those liabilities. Where a penalty arises under the relevant tax laws, a director penalty notice ("DPN") from the ATO typically follows.

The ATO will usually issue a DPN before they take steps to have that company wound up. The primary objective of the director penalty provisions is to cause the company to pay the outstanding liabilities or to have the company quickly brought under some form of external administration to protect the interests of all creditors.

Changes to the director penalty regime were introduced by the *Tax Laws Amendment (2012 Measures No. 2) Act 2012*. Notably, it included changes to the penalty remission provisions. As set out in *PS LA 2011/18* at paragraph 52:

> *"... where a PAYG withholding or SGC liability is notified within three months of the liability's due date remission of the relevant penalty will occur, as under the previous law, if the company is placed into administration or liquidation before a DPN is issued or within 21 days of the DPN being given.*
>
> *However, if the PAYG withholding or SGC liability is not reported within three months of the due date then remission of the penalty relating to the unreported amount will not occur after that three month period if the company is placed into administration or liquidation before a DPN is issued or during the 21 day period following the DPN being given."*

Despite the threat of personal liability for taxation debts, we are still coming across instances where DPNs are being ignored. In one recent case we've been involved with, the directors are now facing bankruptcy which could have been avoided if steps were taken upon receiving the DPN.

In circumstances where penalty notices or some other form of recovery action has been instigated, we suggest you call us to discuss your client's position and what options might be available.

Ending the life of a solvent company — what are the options?

Maintaining unnecessary or dormant entities costs time and money — but it's important to choose the right path to close down a company that has passed its use by date.

As we have been receiving some enquiries on this topic, we thought we'd briefly cover some of the considerations when looking to end (or close) a solvent company.

Firstly, it's worth noting that ASIC may decide to strike-off (deregister) a company that isn't carrying on business and meets some other criteria. This process is generally for 'lost' companies and those that ASIC consider to be dormant. This might seem attractive at first glance (i.e. "just leave it to ASIC") but any assets still owned or held by a deregistered company will vest in ASIC or the Commonwealth. So, for most people it's not really a practical option.

From the director/shareholder viewpoint, there are two options to proactively end the life of a solvent company:

- members' voluntary liquidation ("MVL"), or
- by applying to ASIC to voluntarily deregister a company (assuming it meets certain legal requirements)

We can help guide you and your clients through both processes, and we can generally accept MVL appointments for a fixed fee.

Application to deregister

This is a relatively quick, cost effective and easy process. There are some conditions that need to be met before ASIC will act upon a deregistration request:

- all members of the company agree to the deregistration
- the company is not carrying on business
- the company's assets are worth less than $1,000
- the company has no outstanding liabilities (this includes contingent claims)
- the company is not a party to any legal proceedings

- the company has paid all fees and penalties payable under the *Corporations Act 2001*

In the event that the company meets all the above requirements, the applicant (typically the company's directors) can complete and lodge a *Form 6010* with ASIC. If ASIC is not aware of any issues, it will advertise the proposed deregistration and inform the company. Two months after the advertisement, ASIC will deregister the company.

Members' voluntary liquidation (MVL)

The MVL process is more comprehensive compared to deregistration, and there are a number of steps that must be followed correctly. Because of this, we always recommend that advice be sought from registered liquidators experienced in undertaking solvent liquidations.

There are a number of reasons to follow the MVL path. The most common reasons include:

- the company is no longer trading and is surplus to needs (e.g. from the sale of a business)
- to save ongoing compliance costs –maintaining a dormant entity within a corporate group typically costs several thousand dollars a year in management time and out of pocket costs
- all available tax losses have been utilised
- to distribute remaining assets and capital in a tax effective manner
- as part of a group restructure to better align the legal structure with the operational structure
- the death of a principal or member of the company

Broadly, the initial steps to wind up a company as an MVL are as follows:

- a directors' meeting is held to consider the winding up.
- the directors complete a declaration of solvency and lodge that with ASIC. This declaration is a prescribed form, and must include a statement of the company's assets and liabilities made up to the latest practicable date.
- a meeting of the members of the company is then convened to consider passing a resolution to wind up (there are some timeframes to adhere to).
- the members must then resolve at the meeting to wind up the company and to appoint a person (who has consented) to act as liquidator.

The appointed liquidator will realise any assets of the company, advertise for and pay creditors in full and distribute the surplus to the members of the company according to their shareholding entitlements.

MVL or deregistration?

This is a common question. Both have their own advantages and disadvantages.

Deregistration is certainly cheaper and faster. But an MVL gives more certainty to the end of a company, compared to deregistration.

Our rule of thumb is that an MVL is preferred for companies that have traded in the past, or where the current directors/members do not have a complete understanding of the history of the company.

Finally, a key benefit of an MVL is that it includes a clearance process with the various tax authorities and formal process for receiving and resolving the claims of creditors. These processes can give more comfort for directors/members that there are no hidden or outstanding claims and liabilities.

Please do not hesitate to contact the following team members with any queries relating to this newsletter, or any other business advisory services which FTI Consulting may be able to assist with.

BRISBANE
Ginette Muller
Senior Managing Director
+61 7 3225 4903
ginette.muller@fticonsulting.com

MELBOURNE
Ross Blakeley
Senior Managing Director
+61 3 9604 0601
ross.blakeley@fticonsulting.com

PERTH
Ian Francis
Senior Managing Director
+61 8 6430 1309
ian.francis@fticonsulting.com

SYDNEY
Quentin Olde
Senior Managing Director
+61 2 8247 8017
quentin.olde@fticonsulting.com

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