Byronvale Advisors

Expert, impartial insolvency and pre-insolvency guide

for directors of companies

Contents

This guide is designed to help directors of building and construction companies, hospitality, retail and transport industries.

Introduction

What is The Byronvale Advisors' Guide to Insolvency?

Having been in the industry for over 25 years, we've noticed a lack of concise and accessible resources in educating Australian companies about insolvency. With the onset of COVID-19, we decided it was more important than ever to fill the gap. We created this guide to be the one-stop shop for business owners in Australia to learn everything they need to know about insolvency and pre-insolvency.

We explain all the key information as concisely as possible, including:

- What insolvency means
- What the signs of insolvency are
- How to find out if your business is insolvent
- What you can do to overcome and/or prevent insolvency

Why was this guide made?

At **Byronvale Advisors**, we believe that companies deserve a fair go at regaining and retaining control of their business. To do that, they must be equipped with as much accurate information as possible.

But there are far too many 'consultants' and 'practitioners' that spread and share misinformation about insolvency and company recovery solutions - ultimately making existing problems even worse.

This guide serves to give company directors the right information about insolvency and pre-insolvency in an easy-to-absorb format. We don't want this guide to tell you what to do. We want this guide to help you understand and decide what you need to do to save your company and get it running better.

Who is it for?

This guide is for:

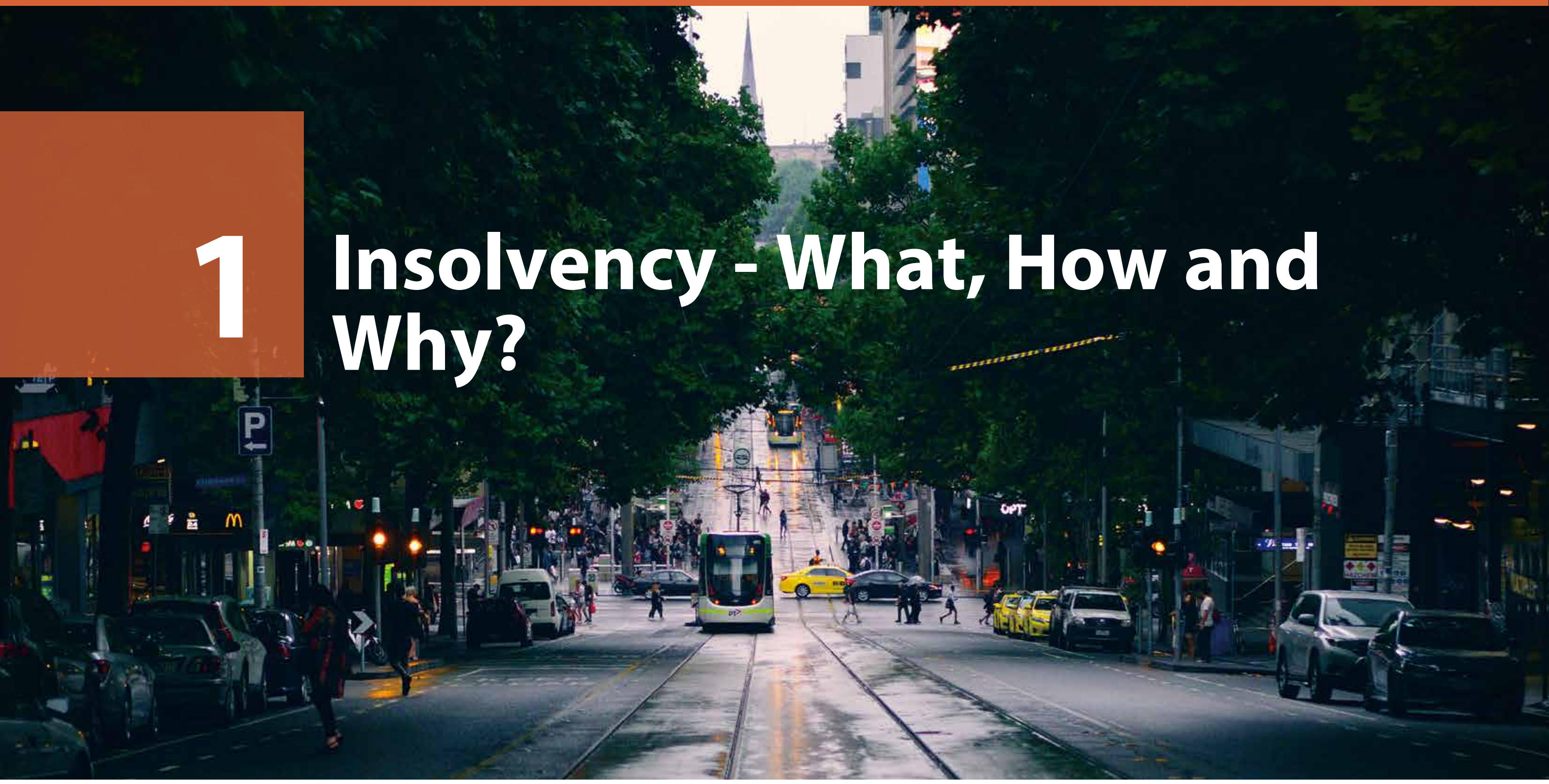
- **Company directors** in Australia who are worried about insolvency and want to regain control of their business.
- **Company directors** with struggling companies who feel like they don't know the first thing about insolvency and what they need to do to save their company.
- **Entrepreneurs and directors** who are not facing the threat of insolvency, but who want to do everything they can to avoid it.

How do you use it?

We have designed this guide to be very user friendly. Unlike other guides that overload information on readers, we have set this one up so you get the information that is **most relevant to you and your situation**.

You don't have to read this guide cover-to-cover. Skip ahead to the sections you think are most important and follow any prompts from those sections to other relevant parts of the guide.

If you have any further questions, you can email info@byronvaleadvisors.com or call 1300 004 404



1 Insolvency - What, How and Why?

In this section, we explain what insolvency is, the industries that are most prone to it, and the trends around corporate insolvency in Australia and how they may change over time.

What is insolvency?

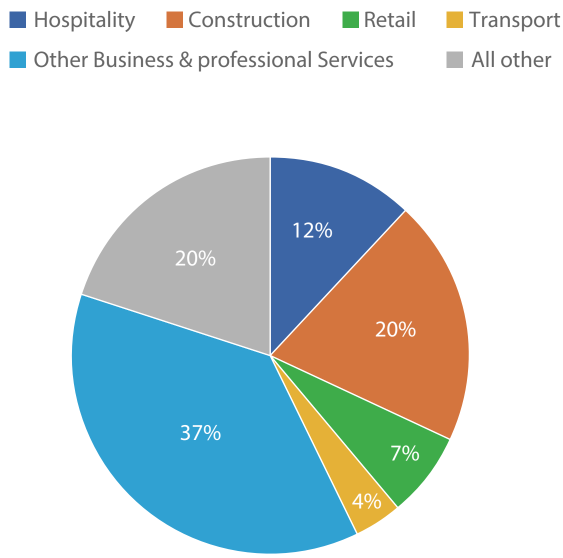
A company is insolvent when it cannot pay its debts as and when they fall due. This can have serious business and personal financial consequences (see Section 2).

Although the rate of corporate insolvency in Australia remained consistent during 2019-20, these numbers may get worse in magnitude over the coming years - depending on the industry.

Insolvency is caused by losses in capital, revenue and credit leading to a tightening in cash available to pay debts. Although many companies are fully aware of their problems, they usually fail to deal with their issues correctly. If companies do not resolve these problems, they will be more prone to sudden, unexpected crises.

In the next few years, several of these industries will see structural changes that may further affect their ability to remain solvent.

Corporate insolvency in Australia

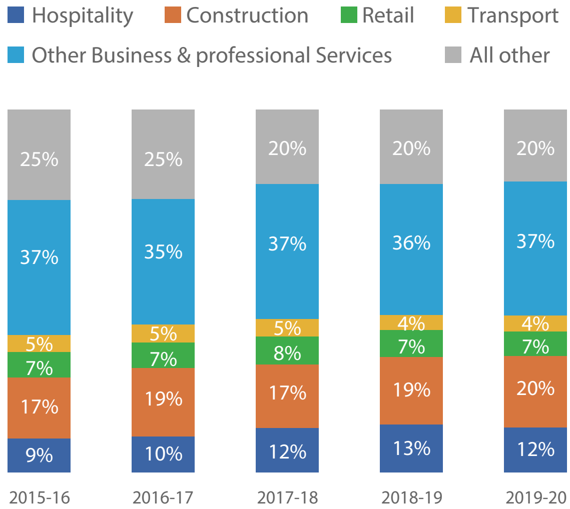


Common industries prone to corporate insolvency

There is a consistent year-on-year, state-by-state trend that shows the same five industries account for 80% of all insolvencies in Australia:

- **Construction**
- **Hospitality and Accommodation**
- **Retail**
- **Transport**
- **Small businesses that support these other four industries, particularly construction**

We will focus on the three biggest ones below.



Construction

20%

of all Australian corporate insolvencies in 2019-20 came from the construction industry

18%

of Australian corporate insolvencies since 2013 have on average come from the construction industry

In the construction industry, the most commonly cited reasons for insolvency are:

- Inadequate cash flow or high cash use
- Poor strategic management
- Poor financial control including lack of records
- Poor economic condition
- Trading losses
- Under capitalisation

The construction industry comprises many small contractors and businesses that supply services to the construction industry. Considering the flow-on effect, it is not surprising that these small unsecured contractors actually make up the largest proportion of insolvencies. If a big volume builder winds up, hundreds of subcontractors would be dramatically affected - especially if that one volume builder makes up the majority of their work, which is normally the case.

Hospitality

12%

of all Australian corporate insolvencies in 2019-20 came from the hospitality industry

10%

of Australian corporate insolvencies since 2013 have on average come from the hospitality industry

There are some key business risks in the hospitality industry that may contribute to companies going insolvent:

- Very high wages.
- High rent/premises costs.
- Vulnerability to economic shifts and changing consumer trends and preferences.
- The highly competitive nature of the industry.
- High fit-out costs for restaurants, payable up front and usually worth a fraction of what it costs to install after a couple of years.

In the coming years, the hospitality industry will change significantly. Companies will have to endure a decline in foreign tourists, shifts in local foot traffic, and changing cost structures. These may make it harder for hospitality companies to survive.

Retail

7%

of all Australian corporate insolvencies in 2019-20 came from the retail industry

7.5%

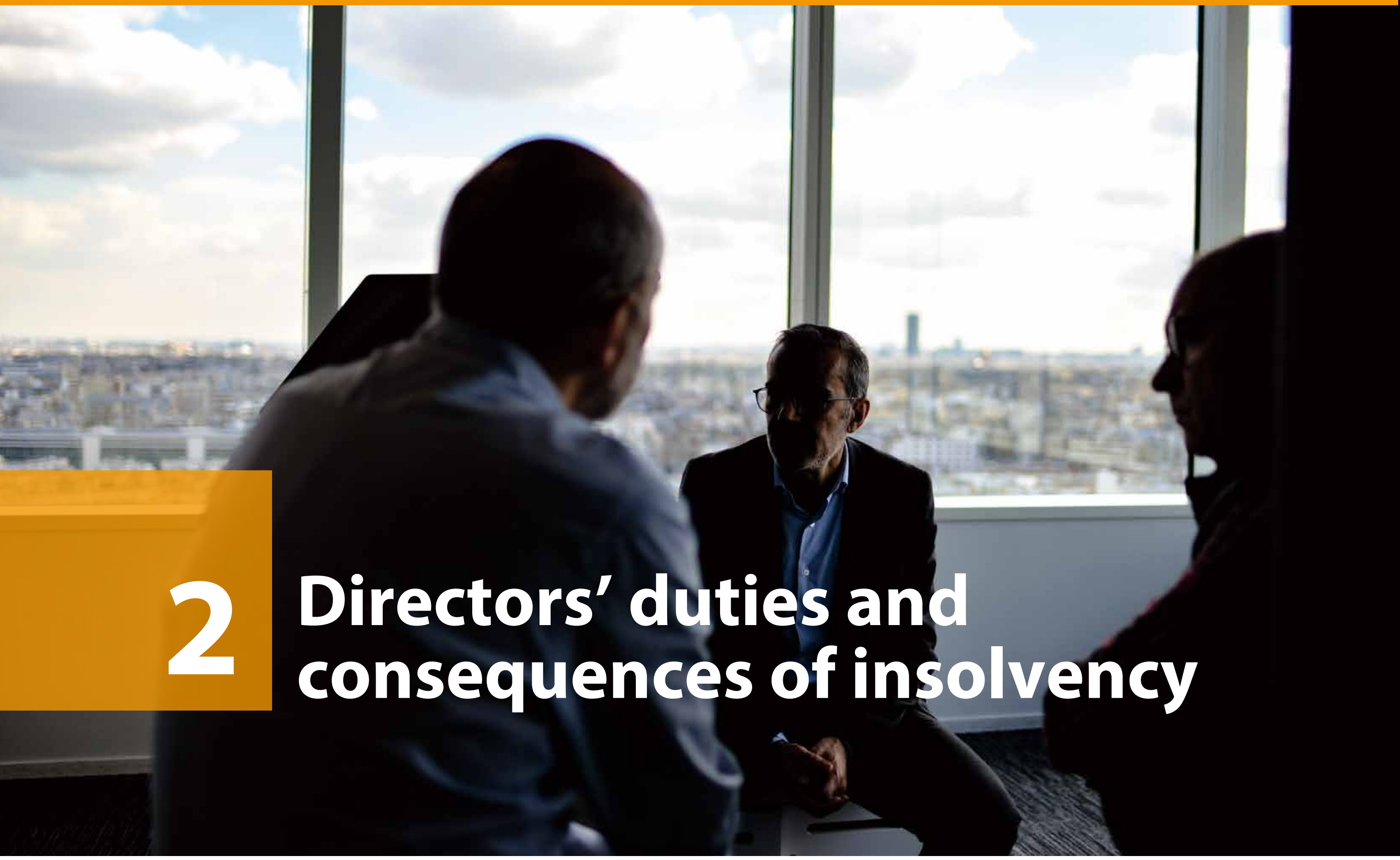
of Australian corporate insolvencies since 2013 have on average come from the retail industry

There are some key business risks in the retail industry that may contribute to companies going insolvent:

- Extremely high wages and premises costs.
- Increasingly lower cost of comparable products being sold online.
- Digital disruption.
- Vulnerability to economic shifts and changing consumer trends and preferences, including a decline in physical attendance in stores.
- Competitive nature of the industry.

In the coming years, these risks make it harder for retail companie to survive.

Learn more: *You can find information on how to know if your company is insolvent in Section 3.*



2 Directors’ duties and consequences of insolvency

Common law duties

Directors have the following duties under Australian common law:

Act in good faith and best interests of the company

Directors’ conduct must align with the company’s objectives and purposes and only exercise their powers for the reasons for which they were given.

Act with care and diligence

Directors must uphold the standards of care, skill and diligence that would otherwise be exercised by a diligent person within reason.

Avoid conflicts of interest

Directors must avoid situations where they have, or are perceived to have, an interest that conflicts, or may conflict, with the interests of their company.
This especially applies to the exploitation of any property, information or opportunity - regardless of whether the company could take advantage of it.

Avoid improper use of company information

Directors must conduct themselves in line with the company’s objectives and purposes regarding the use of company information.

They must act in the way they consider, in good faith, to best use, share or withhold company information to ensure the success of the company.

Duty to prevent insolvent trading (Corporations Act 2001 - s588G)

Section 588G of the Corporations Act states that directors must fulfil a duty to prevent insolvent trading.

A director is in violation of this if:

- They held the position of director when the company incurred the debt; and
- The company became insolvent by incurring a debt or was insolvent at that time; and
- There was reasonable evidence to suspect the company would become insolvent or was insolvent

Further, under section 588M of the Corporations Act, a liquidator may bring proceedings against a director to recover the total debts incurred as compensation, which will be distributed to the creditors. An individual creditor may also bring a claim personally against the director personally amounting to that creditor's individual claim.

Directors must ensure they remain informed at all times to avoid personal liability and are encouraged to seek advice regularly.

Consequences of breaching duties

It is vital for company directors to be aware of their duties and obligations. As a director, if you do not comply with your obligations, you may face serious consequences.

Penalties may be both civil and criminal. Examples include imprisonment, fines, unlimited personal liability for debts, and disqualification from managing a company and acting as a director.

Other consequences of insolvency

Insolvency has implications that reach beyond those of your company leadership position. Insolvency affects your company, your creditors and suppliers, and yourself and your family.

Your Company

Insolvency can cause your worst fears as a business owner - you could lose your business or it may close permanently. Think of your company like your own body - if you don't look after it, it becomes unhealthy and eventually dies. That's why it's important to always be on the lookout for indicators and warning signs of insolvency - regardless of where you are in your business journey.

Learn More: You can find information about potential warning signs of insolvency in Section 3.

Your Creditors & Suppliers

Insolvency means being unable to pay your debts when they are due. If you can't pay your creditors and suppliers on time, you could cause them and yourself a lot of problems. They may not be able to cover their own costs and may end up at risk of insolvency themselves. They may also consider taking legal action against you personally as a director to seek damages.

Yourself & Your Family

Company insolvency can take a toll on yourself and your family. As an entrepreneur, your confidence takes a massive hit when your company becomes insolvent. You could also lose a source of income to provide for your family. Our principal, Stephen Barnes, says, "Every business is a family business." Aside from the financial implications, your family will also be there with you dealing with the stress and anxiety that comes with an insolvent company.

3 How do you know if your company is insolvent?

Signs of insolvency

If your company is insolvent, you should be looking out for some of these warning signs appearing within your company:

- Creditors issuing demand notices to your company.
- You're only getting stock via cash on delivery (COD).
- Your company is behind on its taxes.
- You're not paying employee payments on time.
- You're late with rental payments.
- Putting invoices into your system late.

Note: *This is not an exhaustive list and while your company may be experiencing some or all of these things, it does not necessarily mean you are facing insolvency.*
It is wise to contact a pre-insolvency advisor to help you clarify your company's situation.

Insolvency tests

Pre-insolvency advisors use two tests to determine whether or not a company is insolvent:

- **The Cash Flow Test**
- **The Balance Sheet Test**

CASH FLOW TEST

A cash flow test looks at whether your company can pay its liabilities (or sell its assets fast enough to satisfy its debts) as and when they are due.

The cash-flow test is the main test the Courts use to determine whether a company is solvent or insolvent. The cash-flow test requires an analysis of:

- The company's existing debts.
- Whether the company's debts are payable imminently.
- The date each debt is due for payment.
- The company's present and expected cash resources.
- The dates any company income will be received.

BALANCE SHEET TEST

A balance sheet test involves looking at your balance sheet to work out whether your company would have more assets or liabilities if it were wound up immediately.

If a company's liabilities are greater than its total assets, the company is insolvent.

IMPORTANT!

You must do these two things before you get a cash flow and/or balance sheet test done:

- Construct the balance sheet and ensure that all relevant items are included.
- Do a balance sheet reconciliation.

Note: *The information these tests provide is subjective and no two situations are the same. While you have recovery options including turnaround, restructuring, Safe Harbour, and voluntary administration (including Deeds of Company Arrangement), you may find out more information about these options in Sections 5 and 6.*

It is wise to get in touch with a restructuring and turnaround advisor to discuss which solution is best for you and your situation.

4

What quick fixes can I do right now for my company?

You must have the correct attitude to saving your company from insolvency. If you're not fully committed to rescuing your company, your company won't survive.

With the right attitude, you can do the following things that will help stabilise the company in the short-term:

Business Item	Actions
Cash flow	• Look at each of your overhead expenses and ask yourself, ***"Would the company still be able to serve the customer well if I reduced the costs for this item?"*** • Discuss with your supplier if they will extend their payment terms, but be prepared to honour the new terms. • Invoice more regularly and then actually devote time and effort to not only making sure your customers pay, but that they do so on time.
Inventory	• Slow inventory turn means you have too much money tied up in inventory, so consider reducing your inventory levels. • Look at reducing your stock line items as an extra inventory cost-cutting measure. • Find out if you can renegotiate payment terms for inventory suppliers which will be closer to when you will be able to sell the inventory item and receive money for it.
Sales	• Look at the sales margin for your top ten customers and then factor in the working capital cost. Are you really covering all the costs to serve each of these customers? • Look at each of your sales areas (products and/or services) and consider which ones you may need to abandon – even just until the company's situation improves. • Examine your pricing model in depth and understand how and why you are pricing the way you are.
Expenses	Look at each of your expenses and ask yourself, ***"Could we still adequately serve our customers if we reduce costs?"*** 3 expenses to consider cutting hard and fast are: • discretionary spending • staff • rent
Company financing	Ask yourself, ***"Is the company's debt structure suitable? Does it actually reflect the situation?"***
Company Strategy	Your focus should be on stabilising your company, so be ready to suspend or exit a particular strategy that doesn't cater to that goal.
Taxation	Make sure you lodge all your various tax returns on time and pay your superannuation - even if you are struggling to make your tax payments. This gives you greater options and buys you more time.

Note: *Doing all these things will not guarantee your company's survival. To give your company a better chance of avoiding insolvency, consider long-term informal actions that can save your company. You can find out more about these pre-insolvency options in Section 5.*

5

If you want to save your company

The first thing you need to rescue your company from the threat of insolvency is the right attitude. If you are committed to saving your company, you will be able to get the most out of the following informal pre-insolvency options:

	Turnaround	Restructuring	Safe Harbour
What is it?	A pre-insolvency process by recovering a distressed company through streamlining company operations.	Can be both a formal insolvency and a pre-insolvency process. As a pre-insolvency procedure, it aims to improve the company's finances and structure.	A defence against insolvent trading for directors that may involve a combination of turnaround and restructuring. Allows company directors to retain control.
Who does it help?	Companies at any phase and size.	Companies at any phase and size.	Helps company directors as it serves as a defence against personal liability for insolvent trading.
Aims and objectives	Fixing operational, procedural, and financial aspects of the company.	Fixing financing and structure of the company.	Achieving a better outcome (with a reasonable expectation) for the company than voluntary administration or liquidation.
Benefits	**1.** Stabilise and improve the company so you can take it forward and achieve the goals you set out. **2.** Increases the value of your company so it will be worth more in the event of a sale. **3.** Company processes become more efficient and streamlined. **4.** Saves you time as a business owner, meaning you don't have to stay back late or work on weekends.	**1.** Sets your company up for purpose - either to grow, sell, move and/or expand your company. **2.** A by-product of restructuring is lower personal risk for directors. **3.** Another by-product of the restructuring process is you may secure lower funding and financing costs.	**1.** Directors can incur debts in the normal course of trading for the company. **2.** Directors remain in control of the company during the recovery process without having to hand over to administrators. **3.** Unlike voluntary administration, you do not need to publicly announce your company undertaking Safe Harbour. You get to protect your company's reputation and avoid the stigma of being labelled as a 'company in distress'. **Public companies may need to disclose under continuous disclosure requirements.*
Cost	A turnaround consultant is cheaper than a formal insolvency practitioner* and will help maintain the company's asset value. **Turnaround consultants may generally have a longer engagement than formal insolvency practitioners.*	A restructuring advisor is cheaper than a formal insolvency practitioner*. **Restructuring advisors may generally have a longer engagement than formal insolvency practitioners.*	A Safe Harbour advisor is cheaper than a formal insolvency practitioner*. **Safe Harbour advisors may generally have a longer engagement than formal insolvency practitioners.*

Unlike formal insolvency, pre-insolvency solutions allow management to retain control of the company and do not involve someone coming in to take over the running of the company. The length and extent of pre-insolvency solutions depend on the company's size, the nature of the company's problems and its goals and objectives.

6 If your company is already insolvent

If it's too late for a pre-insolvency solution, you have several formal insolvency options to choose from:

	Voluntary Administration	Liquidation	Receivership
What is it?	When a company is insolvent, the company directors can appoint an administrator who will then try to rescue the company by organising its assets and liabilities.	The process of winding up a company and distributing its assets to claimants. This usually occurs when a company is insolvent.	The court appoints a receiver who works with directors to assist the company's creditors to recover funds in default. This can help financially struggling companies avoid bankruptcy.
Who is in control of the company?	Administrator	Liquidator	Receiver/directors
Whose interests are their main concern?	Creditors	Creditors	Secured creditors
Length of engagement	25-30 business days	6-12 months	Ends when: • The receiver has collected and sold all the collateral to repay the secured creditor. • Completed all receivership duties. • Paid all receivership liabilities.
Aims and objectives	Focuses on achieving a quick resolution towards the company's future direction. The voluntary administrator takes control of the company's affairs to obtain a better return to creditors than if the company had been placed straight into liquidation.	A liquidator takes control of the company so its affairs can be wound up in a fair and orderly way to benefit its creditors.	The primary role of an appointed receiver is to collect and sell enough company property to repay the debt owed to the secured creditor.

Formal insolvency advisors generally have higher prices than informal insolvency consultants and advisors because of added costs including compensation and out-of-pocket fees. These include:

- reasonable fees, or remuneration, for the necessary work they properly perform, after these fees have been approved by creditors, a committee of inspection or a court.
- reimbursement for out-of-pocket costs incurred in performing their role: legal fees; valuers', real estate agents' and auctioneers' fees; stationery; photocopying; telephone and postage costs; retrieval costs for recovering company computer records; and storage costs for company books and records.

The administrator is sometimes not paid (or only partially paid) for the work they do if there are limited assets, or none at all. They may likely ask third parties for a deposit before they begin their engagement to cover the potential shortfall in fees.

Summary: 10 key facts

- **Insolvency is when a company cannot pay its debts as and when they fall due. This has serious financial consequences from a business and personal standpoint.**
  Learn more: You can find out what insolvency is in Section 1

- **You should look out for the warning signs of insolvency appearing within your company. Pre-insolvency advisors use two tests to find out if a company is insolvent - the cash flow test and the balance sheet test.** *Learn more: You can find out how to know if your company is insolvent in Section 3*

- **Before bringing consultants to help rescue your company, you can stabilise your business by taking actions to fix cash flow, inventory, sales, expenses, company financing and strategy, and taxation.** *Learn more: You can find out what short-term fixes you should do for your company in Section 4*

- **A turnaround is an informal process to recover a distressed company by focusing operational, procedural, and financial adjustments and improvements.**
  Learn more: You can find out about turnarounds in Section 5

- **A company restructuring can either be a formal or informal process. As an informal procedure, it focuses on improving the company's financing and structure.**
  Learn more: You can find out about restructuring in Section 5

- **Safe Harbour is a defence against insolvent trading for directors and allows company directors to retain control of the company. This may involve a combination of turnaround and restructuring.** *Learn more: You can find out about Safe Harbour in Section 5*

- **Voluntary administration is a formal insolvency process whereby company directors appoint an administrator who will try to rescue the company by organising its assets and liabilities.**
  Learn more: You can find out about voluntary administration in Section 6

- **Liquidation is a formal insolvency process whereby an appointed liquidator winds up a company and distributes its assets to claimants.**
  Learn more: You can find out about liquidation in Section 6

- **Receivership is a formal insolvency process whereby an appointed receiver works with the company directors to assist creditors to recover funds in default.**
  Learn more: You can find out about receivership in Section 6

- **Under formal insolvency processes, you hand over control of your company to an external party. That means you let go and you don't have to care about the outcome. Under informal insolvency processes, you must have the right attitude and care about saving your company to stand any chance of survival.**

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