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7 things that SME enterprise directors need to be aware of when they hit rocky times

Author:
Ben Sewell of Sewell & Kettle Lawyers

1. What is your end game? Business continuity or business exit?

When a business hits rocky times the directors of small-to-medium sized enterprises (SMEs) need to develop a clear business strategy. If the directors do not have a clear strategy, they may be lost in the details of keeping the business afloat rather than driving towards their end game. If there is a profitable core that is worth saving, there is a choice between: keeping the business and attempting to salvage it or selling the business. It may be necessary to consider the formal appointment of an administrator or liquidator in either situation if the business is insolvent.

2. You cannot develop a strategy without reliable financial information

Reliable financial information will prevent an SME from choosing the wrong strategy and it will give the directors insight into why the business isn't achieving the required rate of return. There are three simple ways to ensure a business has **reliable financial information**:

1. Draw up an annual budget and cash flow forecast and as the year goes on compare the budget cash flow with actual figures;
2. Ensure you know what your product/service costs to produce and what effect it would have on profits if, for example, sales were increased or decreased by 10%;
3. Make sure your assets are valued correctly.

When a business is failing it can be tempting to get 'creative' with accounting and this is one symptom of impending business failure. Beware if you feel tempted to:

- Delay producing financial statements;
- Continue paying dividends (i.e. drawings) by relying on debt rather than retained earnings;
- Cut expenditure on routine maintenance;
- Start treating extraordinary income as ordinary income and vice versa;
- Change ownership title to main assets of the business;
- Value assets at inflated figures;
- Meet company debts out of your own pocket; and
- Value stock of finished products at the current market selling price rather than at cost.

3. Legal meaning of insolvency

A company is insolvent if it is unable to pay all of its debts when they become due and payable. There is no longer an express requirement that your business must be able to pay those debts out of its own funds or assets so if your business is failing it may be able to seek funding from external sources or a related party to be considered 'solvent'.

4. What causes insolvency: poor management, the big project, overtrading or predictable business risk?

The bad news is that the prime cause of business failure is poor management. Here is what to look out for:

- Refusal to seek or take advice: A director should look to advisors who have been through insolvency situations and understand the strategic issues that the business faces;

- Narrow-mindedness: Directors who only show interest in matters that concern their particular area of expertise or interest and especially those that lack finance experience in management or suitable financial advisors

Taking on a **big project** without up-to-date financial information and reasonable forecasts where costs and times are likely to be underestimated and/or revenue may be overestimated is another mistake that leads to failure. **Overtrading** is another major cause of failure where challenging targets are set but the cash flow effects of expanding a business are not properly measured before execution. If your business is already in precarious circumstances (such as overtrading or taking on the big project), an otherwise **predictable business risk** may cause your business to fail. These risks will not cause a healthy business to fail. There is no way to prevent normal business risks

5. The difference between administration, liquidation and receivership

Administration functions as a way to rescue or revive insolvent companies that have some going concern value worth preserving. If a business goes into administration the business will carry on, however, it will be operated by the administrator appointed voluntarily by the directors. During this time options aside from liquidation will be considered such as recapitalising or selling the business.

Liquidation on the other hand, is the process by which a business is brought to an end. At this point the assets of the company will be sold off and the business activities terminated. Liquidation may, as with administration, be entered into voluntarily or involuntarily.

Receivership is where your financier appoints a receiver to take control of the assets and undertakings of your business and collect a loan.

6. Insolvent trading actions by liquidators against directors

A liquidator can make a claim against directors of a company in liquidation if they incurred debts whilst the company was insolvent.
Informal leniency by creditors will not necessarily affect when the debt is considered to have fallen due. The defences available to directors against insolvent trading claims are that there were reasonable grounds to expect that the company was solvent and would remain solvent. Directors should also ensure the company financials are up-to-date because a Court will presume a company to be insolvent if it fails to retain books and records.

7. Directors may become liable for unpaid employee Super and DPN claims

On 29 June 2012 the Pay as You Go Withholding Non-Compliance Tax Act 2012 wawas passed. The changes imposed by the legislation will place more personal obligations on directors in insolvency scenarios.

The following changes have been made by the legislation:

- Directors are no longer necessarily discharged from personal liability because the company was placed into administration or liquidation;
- If superannuation guarantees or PAYG is unpaid and unreported for three months after the due date, directors will be held liable;

- The Deputy Commissioner of Taxation now has powers to estimate assessments of unpaid superannuation;
- The Commissioner can now issue a Director Penalty Notice to the director's registered tax agent;
- Directors and their associates may be held liable to a PAYG withholding non-compliance tax where a company has failed to remit amounts withheld;
- Directors and their associates will not be able to access PAYG credit in their own tax returns where a company has not paid the ATO