FOR ACCOUNTANTS IN PUBLIC PRACTICE

Helping clients with companies in financial distress

In these difficult and challenging times, many accountants will have clients coming to them seeking advice and looking for options in relation to current or anticipated financial distress.

The options available to your clients will depend on their solvency status. This article covers the concept of corporate insolvency, how this affects the options available to your clients and where to go for specific insolvency and turnaround advice.

Be careful about who you turn to for specialised advice

When your client is in financial distress, it's important to help them choose their adviser very carefully. Because nowadays there are many unscrupulous and unqualified 'pre-insolvency' advisers spruiking their services on the internet or even via direct contact.

It can be difficult to discern between unregulated, unqualified advisers and reputable, legitimate advisers, because pre-insolvency advisers utilise slick advertising and websites that make them appear to be legitimate and trustworthy.

They will often claim to remove the worry of difficult financial situations and help avoid legal duties. But taking their advice may make your client's situation worse and put them on the wrong side of the law. They may encourage your client to move assets or destroy books and records – recent law changes mean that such actions would be offences with serious consequences for your client and possibly their advisors and any asset transfers will be reversed.

The best way to avoid bad advice is to deal with only a Registered Liquidator or a lawyer with additional insolvency law qualifications, and preferably those who are ARITA Fellows and Professional Members.

ARITA Fellows and Professional Members are fully qualified in the intricacies of Australia's complex insolvency laws. Because they're also experts in restructuring and turning around businesses of all sizes, they can help your client understand their financial position and options, and help them set a path forward.

If you want to verify if someone is an ARITA qualified practitioner, please go to arita.com.au/Member[1] which has a list of all Registered Liquidators who are ARITA Professional Members or Fellows.

When is a company insolvent?

A company is solvent if it is able to pay all its debts as and when they are due and payable.

The law defines insolvency by reference to that standard, and a company is **insolvent** if it is **unable to meet its debts as and when they are due and payable**.

However, the determination of insolvency at a point of time can be a challenging assessment. It requires a careful and honest assessment of the company's financial position, taken as a whole. It needs to cover debts which are currently due and also those which may fall due in the near future.

Importantly, the legal definition of insolvency focuses on a **cash-flow** test. However, the company's balance sheet, available assets and the commercial realities will be relevant to a consideration of what resources (including external sources of funding) are available to a company to meet its debts when they are due.

Temporary liquidity challenges

Insolvency is characterised by an 'endemic shortage of working capital' which needs to be distinguished from temporary challenges to short term liquidity.

Given the current impact of the COVID-19 pandemic, there is a strong likelihood that businesses' liquidity will be adversely impacted. Ensuring that the challenges to liquidity do not move into a shortage of working capital which is unable to be overcome, is key to maintaining solvency during this period.

The relevance of commercial realities to the assessment of solvency means that it is permissible, and appropriate, for companies to consider a variety of resources available to them to maintain their cash flows. These may include:

- cash reserves
- financial support (from directors, associated companies or others)
- assets which may be realised in the short term
- government support packages which may be available
- talking to banks, lenders, secured creditors, suppliers, trade creditors and landlords to obtain accommodations and extensions to debts which are due or about to fall due.

Endemic shortage of working capital

The flip side of a temporary shortage of working capital, which a business may be able to work through for a short-medium term period (depending on their circumstances), is an 'endemic shortage of working capital'.

For companies which may have already been operating under severe financial distress, the impacts of the COVID-19 pandemic may move them into a position where it is not possible to recover.

If a company is unable to readily access alternative methods for financial support, it may have already crossed the line into legal insolvency.

Due & payable

The important date is when debts are legally due, having regard to the agreement reached between the parties. If a company has reached an agreement with creditors to extend payment terms to a standstill period on current indebtedness, or some other informal arrangement to change trading terms, these should be recorded in writing.

If there is no formal agreement to change the date when a debt is due to be paid, then it should be treated in the company's cash flow analysis as a present debt. An agreement not to enforce a debt which is due is not the same as an agreement which alters the terms of when the debt will be due.

Importantly, for tax-related debts, even where the ATO has made an allowance or accommodation of the recovery of tax debts, this generally will not change the legal due date for the obligation. It is important to understand the nature of what the ATO has agreed to do.

Why is determining insolvency important?

If a company is on the brink of insolvency the directors need to take action immediately for two reasons:

1. If they act quickly, they may be able to save the business or, at the very least, minimise the consequences.
2. If they trade a company while it is insolvent, they could be breaking the law. Insolvent trading is a criminal offence which may impact their personal financial position.

Options?

Distress level	Options
Doubts about solvency and whether there is a viable business	• Restructuring with safe harbour protection (outside a formal insolvency appointment) • Voluntary administration with a deed of company arrangement to compromise debts and give the company opportunity to restructure (a formal insolvency appointment)
Insolvent but there could be a viable business	• Voluntary administration with a deed of company arrangement to compromise debts and give the company opportunity to restructure (a formal insolvency appointment) • Liquidation (a formal insolvency appointment) involving a sale of the business
Insolvent and no viable business to save	• Liquidation (a formal insolvency appointment)

What do each of these options mean?

Restructuring with safe harbour protection gives directors the opportunity to restructure the business outside of a formal insolvency appointment, with protection for directors from insolvent trading laws in the event that the restructuring is unsuccessful and the company ends up in liquidation. The directors remain in control of the company throughout this process and a restructuring adviser will work for the company and assist the directors. There are rules around this option (see below under 'Safe harbour') and it is only appropriate where there is a viable business to save with assets and cashflow to support the restructuring process.

Voluntary administration followed by a deed of company arrangement (deed) is a formal insolvency appointment and a Registered Liquidator is appointed to control the process (called the voluntary administrator). The voluntary administrator acts for the creditors. The directors may be the party that puts together the deed which is considered by creditors. This might be a payment plan over time, or the contribution of further funds from a third party, and it usually involves creditors agreeing to compromise their debts.

The voluntary administrator reports to creditors and creditors decide whether to accept the deed proposal. If creditors don't accept the Deed proposal, or no proposal is put forward, the company will usually end up in liquidation. This is a good option for companies that are, or are likely to become, insolvent, but still have a viable business to save.

Liquidation Once a company is insolvent with no viable business to save, the only option is liquidation. In a liquidation, a Registered Liquidator is appointed to control the process (called a liquidator). The liquidator acts for the creditors. The liquidator recovers available assets, investigates the company's affairs and distributes any available funds to creditors. Liquidators will also investigate the decisions taken by the directors in the lead up to the liquidation, and directors can be responsible to compensate the company for matters such as breaches of directors' duties, insolvent trading or unreasonable director related transactions.

Liquidators may also sell a viable business. However it is important to recognise that sale of business options in any form of formal appointment may be limited in a distressed economic environment.

Safe harbour

There's some good news if your client's company is in financial distress. Australia has 'safe harbour' laws that are designed to help protect company directors who attempt to do the right thing and turn their company around lawfully, even if they are technically insolvent.

There are important steps, which are legal prerequisites, that directors must take to protect themselves as well as giving their company the best chance to get back to profitability:

1. **Get financial records in order**

   Directors can't get the protection of a safe harbour unless the company's books and records are in order. As your client's accountant, this is where you can help. It is vital that the company knows where money is coming from or going to, otherwise it is impossible to have a plan to solve the problems your client's business is facing. It's also vital to understand where the debts may be and how much the business really owes, including tax debts. This is important in determining if your client's business is actually viable.

You also need to make sure that the company has complied with its obligation to pay its employees (including their superannuation) and its tax reporting obligations.

2. **Expert help**

   The law requires that directors get advice from an appropriately qualified adviser. As a client's first point of contact, accountants can assist their clients with ensuring the financial information is in order. When it comes to getting specific safe harbour advice, your client is going to need to speak to an insolvency expert. The most qualified insolvency experts are always going to be Professional Members and Fellows of ARITA – Australian Restructuring Insolvency and Turnaround Association. The sooner your client seeks expert advice, the more options they are likely to have.

3. **Directors must properly inform themselves of their company's financial position**

   So, your client has got their financial records up to date, they have taken advice from a qualified adviser and now they must make a decision about where to from here. The law says directors have to decide if the proposed restructuring plan is 'reasonably likely to lead to a better outcome for the company and the company's creditors than if it had entered into voluntary administration or liquidation'. And that's why the advice from a properly qualified professional is vital.

4. **Develop & implement a restructuring plan for the company**

   The law – and common sense – says directors must have a properly documented restructuring plan for their company. It's important that it's documented, not just for them to be able to check off that they are following the plan, but also if the turnaround doesn't work, to ensure your clients can avail themselves of the safe harbour protections.

   A restructuring plan doesn't need to be long or complex. As long as it has clear and appropriate steps to getting your client's company back to financial health and, importantly, as long as your client follows that plan.

Differences for SMEs & large businesses

The law doesn't distinguish the treatment of financial distress between different sizes of businesses.

In a practical sense, the main difference is the size of the response to distress. Engaging a restructuring or insolvency professional doesn't need to be onerously expensive if your client is an SME. Indeed, the majority of insolvency and turnaround professionals work in small firms themselves.

If your client is a larger business, they will likely need a larger, and likely industry specialist, team to work on the turnaround.

Financial distress can be tough emotionally

Having a company in financial distress is a crushing experience. We recognise that it's likely to be personally hard on directors.

It's important to ensure directors are aware of, and look after, their mental health. Because the most important thing is that they get through these challenges. If you feel it's appropriate, you can recommend they chat to their doctor, check out Beyond Blue[2] or call Lifeline[3] if they're in urgent need of help.

Where to from here?

There are good options to helping your clients through financial distress. But expert advice is key – an ARITA Fellow or Professional Member can be part of the solution.

For your client's financial health, make sure you don't refer them to some of the dodgy advisers who may offer their service through Google advertising. Often their only qualification is that they've been bankrupt before.

Disclaimer

Document links

1 https://www.arita.com.au/member

2 https://www.beyondblue.org.au/

3 https://www.lifeline.org.au/

ARITA AUSTRALIAN RESTRUCTURING INSOLVENCY & TURNAROUND ASSOCIATION

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