Corporate Insolvency in Australia

Australian Council of Trade Unions submission to the Parliamentary Joint Committee on Corporations and Financial Services inquiry

ACTU Submission, 22 February 2023

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ACTU

australian council of trade unions

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About the ACTU

Formed in 1927, the ACTU is the peak trade union body in Australia. There are 42 trade unions affiliated to the ACTU which together have over 1.7 million members engaged across a broad spectrum of industries and occupations in the public and private sector.

For over 90 years, the ACTU has played the leading role in advocating for, and winning, improvements in wages and working conditions. During this time the ACTU has advocated for law reform on almost every Commonwealth legislative measure that concerns employment conditions and/or has implications for working people, their families and the community. The ACTU has appeared before the Fair Work Commission and its statutory predecessors, in numerous high-profile test cases, as well as annual national minimum and award wage reviews.

1. Introduction

The ACTU welcomes the opportunity to make a submission to this inquiry of the Parliamentary Joint Committee on Corporations and Financial Services because working Australians, their families and the wider community have a vital interest in the long-term viability and sustainability of well-governed and competently managed businesses (however they are structured) that provide secure, well-paid jobs.

When businesses fail and enter formal insolvency direct and indirect employees (labour-hire, dependent contractors) risk losing and/or having delayed access to entitlements, are exposed to financial hardship and stress precipitated by sudden job loss, involved in protracted wind-ups and then being permanently detached from the labour market or forced in precarious work. In this context employees, especially older workers, can't afford 'to learn through failing' and face catastrophic setbacks in their standard of living and future well-being when the business they work for fails. Many workers get no real second chance because the capped Federal Entitlements Guarantee (FEG) excludes, in whole or in part, untaken sick leave, unpaid non-ongoing payments/commissions, unpaid voluntary and superannuation guarantee contributions, accrued time (such as TOIL), long standing wage underpayments and unremitted payroll deductions to nominated third parties.

The ACTU and its affiliates have been involved in dealing with the consequences of high-profile corporate failures such as Ansett, Queensland Nickel, and Virgin Australia. However, every day unions are representing their members in insolvencies and business-related bankruptcies that go unheralded in the media but nonetheless impose significant costs on workers, their families, the communities in which they live and on the wider public. For this reason the ACTU has contributed to the Productivity Commission's consultations during its 2015 Inquiry into Business Set-up,

Transfer and Closure and made submissions during inquiries into the misuse of the Fair Entitlements Guarantee. Relatedly the ACTU made a joint submission to the Treasury on the establishment of a beneficial ownership register and the current review of the Modern Slavery Act. The ACTU intends to make a submission to this Committee's announced inquiry into ASIC's capacity and capability to respond to reports of alleged misconduct.

This submission provides a broad overview of the key issues with insolvency and bankruptcy. It is by no means a comprehensive statement on the topic from Australian Unions. In this regard we support and commend to the Committee other submissions made by trade unions to this inquiry.

Context

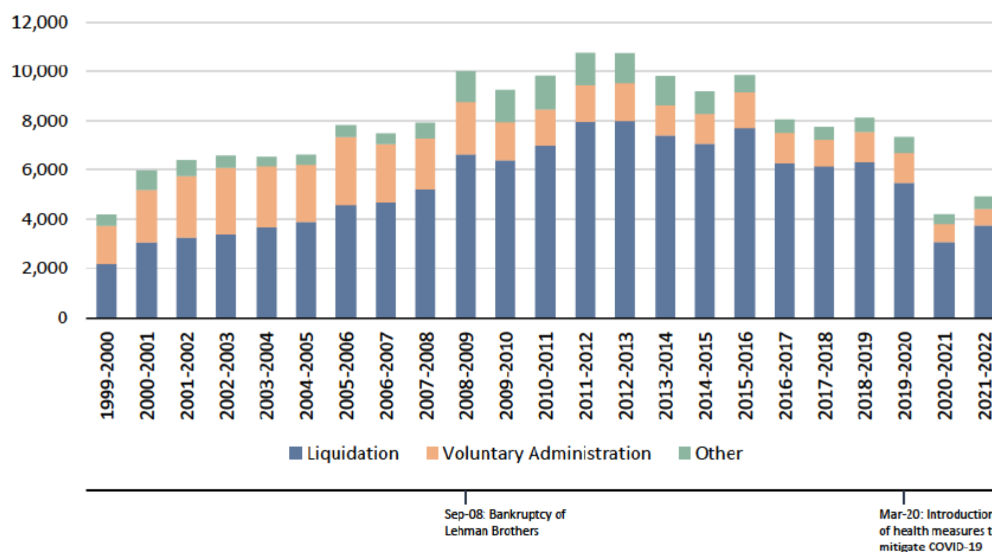
From the outset is it useful to restate some important facts that help characterise and contextualise Australia's insolvency and bankruptcy regime and identify the focus of future reform efforts:

01. Micro and small businesses make up 80% of all business exits including formal insolvencies and/or personal bankruptcies Source ASIC;
02. Five industries are **historically over-represented** in insolvencies - construction, food and accommodation services, business and personal services, retail and labour hire (Source ASIC). Unsurprisingly these industries also exhibit high levels of phoenixing, wage and super theft, tax evasion (see Ahmed & Braithwaite 2005), and modern slavery abuses (Source Treasury ATO, Industry Super Australia);
03. While number and rates of insolvencies typically rises during economic downturns there have been structural breaks[1] which, from 2000/2001 onwards, have driven aggregate failure rates higher in Australia (see Kenny, La Cava & Rogers 2016). Covid measures suppressed the influence of those structural drivers but they appear to be again reasserting their influence.

[1] Kenny, La Cava & Rogers 2016 p. 1 observe that .. *"Several events occurred around 2000/01 which may have led to a permanent rise in the average company failure rate. These include: the introduction of employee entitlement schemes which effectively reduced the cost of companies entering insolvency; the introduction of the goods and services tax (GST), which may have increased the cost of being a registered company; and legislation introducing harsher penalties for trading while insolvent. The structural break also appears to reflect measurement issues and, in particular, an increase in the share of registered companies that are 'inactive'."*

04. Since the global financial crisis liquidations have dominated formal insolvencies as opposed to voluntary administrations and all other types (Source ASIC/Treasury);

Figure 1.2: Number of companies that have entered external administration or have had a controller appointed per financial year (1999-2022)



Source: ASIC Insolvency Statistics Series 1.

05. While two in every three formal insolvencies are, on average, director-initiated many are involuntary - ie only commenced **after directors receive a DPN** (Director Penalty Notice) from the ATO (Source ATO);

06. External administrator and liquidator reports **consistently** point to lack of management skills and undercapitalisation as causal factors of insolvency (Source ASIC). Already weak undercapitalised firms (cited in 27% of reports) find it harder to recover from poor strategic decision making (cited as a factor in 40% of reports). Poor record keeping (cited as a factor in 32% of reports) results in poor cashflow management (cited as a factor in 48% of reports) and trading losses (cited as a factor in 45% reports). Wider economic factors are an extra stressor but recede as a contributor to failure when business conditions are more benign;

07. There is an increased likelihood the directors of insolvent companies being involved in multiple related and future insolvencies (Source Australian Government 2017 FEG Consultation paper, ASIC);

08. This pattern translates into external reports citing possible director misconduct in three areas - failure to keep proper records, insolvent trading and breaches of directors' duties. Misuse of office is a fourth area which reflects criminal motivation (Source ASIC);

09. 90% of insolvent companies have liabilities less than $5 million and 70% have liabilities less than one million dollars (Source ASIC)

10. Most corporate insolvencies (90%+) result in **nil recovery** ie total loss to creditors (Source ASIC);

11. 40% of individual bankruptcies are attributable to related business failures (Source ASIC/AFSA);
12. 80% of registrations in the Personal Property Security Register are categorised as commercial property (Source AFSA);
13. Since the inception of it and its predecessors, the Fair Entitlement Guarantee has cost the taxpayer $1.3 billion. Of that just under $200 million (14%) has been subsequently recovered during formal insolvency processes (Source Treasury/Attorney General);
14. Insolvency debt owed by small business, private companies and multinational corporations to the Commonwealth currently stands at $8.4billion (Source ATO Annual Report);
15. Relatedly the small business sector is responsible for over 65 percent of the ATO's outstanding collectable debt ($29.3 billion). This equates to roughly 80 percent of the current budget deficit (ATO);
16. The ATO is creditor in 75% of insolvencies and very often the only creditor (ATO).

Explaining why companies fail

The picture painted above provides some inferential insights into the causal factors driving company distress and insolvency (especially those from liquidators reports). Kenney, La Cava and Rogers observe that up until their 2016 RBA research discussion paper there had been limited research on causes of corporate failure in Australia. Using data drawn from the entire population of registered companies they found:

- **Corporate failure is more likely** when companies have **high leverage, low liquidity and low profitability.** Further that leverage is typically related to trade credit;
- Aggregate conditions, such as the macroeconomic environment, appear to accentuate the **annual level** of the corporate failure rate;
- Proprietary companies have a much higher probability of failing over short (<5years old) and medium time horizons (>5 - <10 years). Over much longer time horizons public companies aged >10 years, and in particular, listed public companies, are more likely to fail than comparable unlisted public and proprietary companies;
- Structural and cyclical characteristics together appear to determine the relative riskiness of companies;

These findings are similar to patterns of failure in a UK study by Wilson, Wright and Altanlar (2014) which examined the failure- survival trajectory of an entire population of newly incorporated companies. In addition, their study found that new firms are less likely to face insolvency when they have boards with more experienced directors, directors with greater

networking relationships, more local directors, more female directors, directors with low levels of recent insolvency experiences and low levels of recent director turnover. Moreover, their exit model suggested that a greater number of current directorships per director increase the likelihood of non-insolvency-related dissolution for new small firms. High levels of family management, more directorship experience and a high level of local networking relationships significantly reduce insolvency risk for new small firms.

An earlier but influential study by Harhoff, Stahl & Woywode (1998) took an even broader look at business failures in Germany. Their's was another large cohort analysis which examined insolvencies/bankruptcies across all business structures – sole traders, partnerships, proprietary companies and public companies. The authors found failure rates to be higher in the same high-risk industries and for younger and smaller proprietary companies.

Taken together then, the descriptive picture painted above and large-scale empirical studies, both here and overseas, strongly supports the conclusion that the risk of liquidation is highest over the short to medium term for a small to medium sized undercapitalised proprietary company which operates in a high-risk industry and/or whose sole director has a recent history of insolvency.

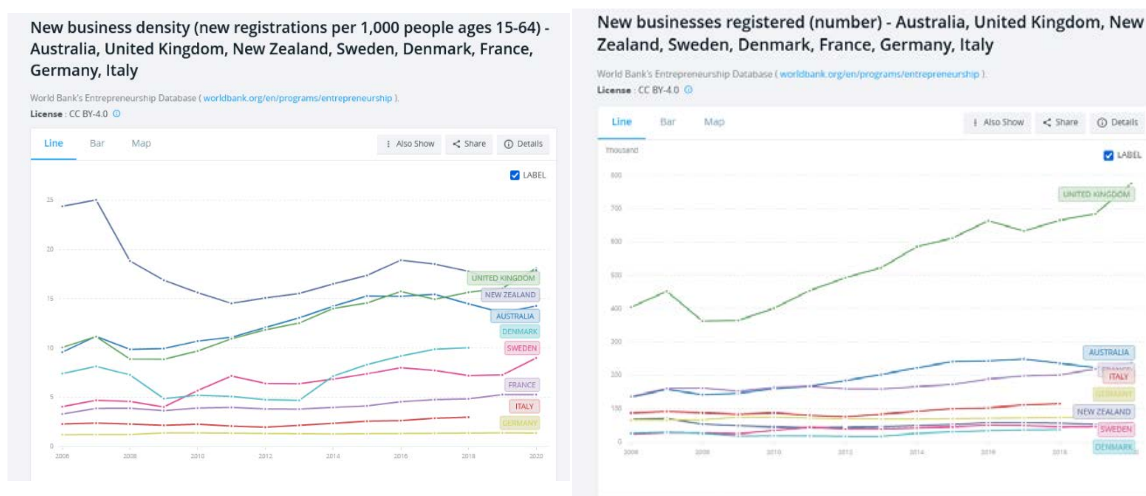
The elevated insolvency risks of single owner/single director proprietary companies, and conversely lower risks of unlimited liability structures, points to individual director characteristics and motivation to incorporate as also being and important causal drivers in insolvencies. In this regard there is a complimentary body of small business research, exemplified by Mazzorol, Reboud and Clark (2015), that identifies inadequate record keeping, poor management and strategic decision-making being rooted in a lack of knowledge of basic business concepts, and relatedly, a reluctance to use financial and accounting information. The growing proportion of liquidations (versus administrations), rising FEG costs and business-related tax liabilities also suggests proprietary company directors' poor knowledge of business basics and use of financial information is a major problem. Regarding motivation, the moral hazard issue identified in the quote from Kenney, La Cava & Rodgers (2016) footnoted on page 2 is a factor driving the creation of complex groups of related entities used to facilitate sharp practices such as phoenixing. For example, an Australian National Audit Office report (No.32 2018–19) reviewing phoenixing taskforce effectiveness noted that a single disclosure identified 110 persons of interest who were involved in the creation of 4412 companies and trusts.

At this point the ACTU wishes to take issue with the assertions (a) that high numbers of business entries is in and of itself a useful indicator of innovation and efficient allocation of capital; and (b) relatedly high numbers of exits are to be viewed as a necessary and unavoidable cost of this capital allocation process. This view, popularised in the Productivity Commission's 2015 inquiry

report on business entry and exits, has been used to support the previous Government's focus on cutting business red tape and 'encouraging' entrepreneurship. These assertions continue to undermine our understanding of the causal drivers of business failures and the policy responses required to reduce the cost of insolvencies being externalised on others.

Then, and now, there is little empirical support for this view. For example highly trade exposed countries renowned for innovation, have much lower rates of business formation than Australia (See graph below). In nominal terms there were as many new businesses registered in Australia as in France, a country with more than twice the population and with an economy twice as large (source World Bank). The latest survey release from the ABS's *Innovation in Australian Business* series also casts doubt on the proposition that raw numbers of new entrants is a good proxy for innovation. It reveals small businesses employing 0 - 4 people were the least likely to innovate. The most significant barriers to innovation is lack of capital and costs rather than so called 'red tape' factors such as adherence to standards or government regulation and compliance. Of concern to this inquiry is the finding that, with the exception of retail services, innovation is lower in the industries with the highest rates of insolvency.

While 'quality' start-ups do benefit the economy, high rates of entries and exits (churn) in Australia suggest too many are starting businesses here without the skills and financial resources necessary to succeed. This is especially problematic in industries that already exhibit high failure rates, a poor track record of innovation and have a culture of sharp practices. In too many cases the cost of failures are being externalised on the wider community without any requisite increase in economic welfare. Given the chronic undercapitalisation, from inception, of many failed companies, it is difficult to sustain the argument that their entry and probable exit contributes to the efficient allocation of capital in the Australian economy (see Blanchflower 2004). If anything it works against it.



Direction of future reforms

Given the context in which most formal insolvencies and business related personal bankruptcies occur in Australia (ie undercapitalisation, poor management and in many cases breaches of directors duties) focusing on reviving companies when they enter formal insolvency will be ineffective. Any future reforms of the insolvency and bankruptcy regime directed at encouraging 'entrepreneurship' though stigma-free, consequence-less failure ignores the reality of long run patterns of insolvencies. The likelihood of insolvencies begetting insolvencies is also a key finding in overseas research. For example several studies (UK Wilson, Wright & Altanlar 2017, Netherlands Wakkee & Moser 2016) finds directors of insolvent companies tend to repeat past mistakes and that failure is not, for the most part, used as 'learning' experience. As such any insolvency reform agenda predicated on encouraging entrepreneurship through failure would be also counterproductive and only encourage base dishonesty at the expense for workers, creditors and the public. We already know that in addition to the direct costs of insolvencies sharp practices associated with multiple failed directorships such as phoenixing and creating assetless subsidiaries, undercuts and crowds-out legitimate business, increases costs to consumers, degrades industry productivity and damages the wider economy.

The ACTU is strongly opposed to Australia's formal insolvency and bankruptcy regimes being made more permissive, for example, by loosening the strict criteria that currently allow directors to access 'safe harbour' protection if they suspect they have been trading insolvent but are confident of a rescue. The extremely low take up of the safe harbour provisions is the result of criteria which only allow safe harbour restructuring if there are no outstanding worker entitlements. Given the above reality the focus of legislative reform and regulatory action should be on systemically reducing the incidence and wider costs of formal insolvencies by attacking the root causes overviewed above.

2. Recommendations

We encourage the Joint Committee to adopt the following recommendations. These draw on the discussion above and our responses to the terms of reference (sections 3-7 following) and can be divided into two groups.

Firstly, recommendations designed *ex ante* to systemically reduce the number and cost of insolvencies and business-related personal bankruptcies.

The second group relates to improving the *ex-post* (ie once a corporate entity enters administration) functioning of the corporate insolvency and personal bankruptcy system.

A. Systemic reforms:

i. **Employee entitlements**

a. Uncap and expand the Fair Entitlements Guarantee - employee entitlements, including all deductions and contributions (including super), are fully recoverable from the FEG;

b. Explore more accessible options to secure employee entitlements against the assets of an employer or place them in trust;

c. Inquire into the feasibility and options for a national long service leave standard and the portability of long service and other leave entitlements;

d. Mandating the payday remission of superannuation contributions via single touch payroll.

ii. **Capital adequacy**

a. Increase the minimum paid up capital of new and existing limited liability entities from a nominal amount ($2) to a substantive amount;

b. Require the Australian subsidiaries of offshore structures to maintain minimum capital, provisioning and additional liquidity buffers to cover outstanding onshore liabilities. Prohibit the use of letters of comfort supplied by offshore entities to assetless onshore entities;

iii. **Corporate governance and business structures**

a. Mandate the public disclosure of all related and associated entities of corporate groups (including trusts, partnerships and joint ventures);

b. Mitigate against the creation and abuse of assetless subsidiaries and related entities by extending common pooling to all solvent group and related entities of an insolvent entity;

c. In circumstances where ASIC suspects directors or officers are breaching their duties to keep proper records and are

trading insolvent it should have the power to seek interim orders seeking temporary disqualification. Where an external report identifies breaches of directors' duties leading to insolvency the corporation act should be amended to provide for automatic disqualification of directors and officers (see recommendation B);

d. Expanding directors duties to include a requirement to inform and consult with employees and their union representatives if a company or its related entities is experiencing distress (ie before the directors form a view about its solvency);
e. Prohibition on directors and officers of companies in distress from registering new companies, acting as shadow directors and/or appointing known associates as directors or officers, or becoming a shareholder where they alone or together with known associates can exercise effective control over an entity;
f. Introduce a compulsory basic business concepts test for all new proprietary company directors and trading trust trustees;
g. Consider the introduction of advisory boards for sole director proprietary companies or alternatively mandate that boards have a minimum of three directors;

iv. **Transparency**

a. Require all proprietary companies and other business entities and structures to lodge audited financial statements with ASIC;
b. Establish a trading trust and trustee register with public access to documents such as the trust deed and details of beneficiaries;
c. Introduce fee free register searching and downloading of company and trust details and documents filed with ASIC

v. **High Risk Industries**

a. Intensify multi-agency, cross-jurisdiction cooperation, auditing, inspections and enforcement actions in industries that exhibit high rates of insolvency and related misconduct such as phoenixing, modern slavery and

migration abuses, wage and super theft, tax avoidance and non-payment of workers compensation premiums;

b. Introduce a national labour hire licencing regime.

B. Insolvency system design and functioning

i. Preferences in claims

a. direct employees and dependent contractors have priority standing in corporate insolvencies

ii. Avoiding Conflicted Appointments

a. Amend chapter 5 of the Corporations Act to include a statement of public interest objectives and principles;

b. Creation of a Commonwealth Companies Insolvency Service (hereafter referred to as ASIC-CIS) attached to ASIC to oversee all insolvencies, work with and complement the Commonwealth's Official Trustee in Bankruptcy (attached to the Australian Financial Security Authority)

c. The appointment of external voluntary administrators and liquidators should be by ASIC -CIS from a public panel.

d. Receivers should be appointed by ASIC-CIS from a public panel.

e. Voluntary administrations should be conducted by ASIC appointed registered liquidator and report to ASIC-CIS in the same way they do for liquidations. Deeds of arrangement should be subject to public scrutiny and CIS should provide or fund independent advice about its impact on other parties;

f. A range of parties should be able to initiate examinations, administrations or liquidations by way of application to ASIC-CIS

iii. Corporate Trusts

a. In the context of insolvencies the conduct of corporate trusts and trustees should assessed using the same principles that apply to limited liability entities and directors (for example on creditor defeating dispositions)

b. The examination and resolution of insolvent corporate trust structures should come under the purview of ASIC-CIS rather than the courts.

iv. Resourcing and Liquidator Renumeration

a. Funding for all external administrations and liquidations not conducted by ASIC-CIS should be according to a set scale of fees;

b. Cost of the CIS and remunerating external liquidators in assetless liquidations should be borne by new entrants through business licencing and company registration fees/levy. In lieu of this the Assetless Administration Fund (AAF) should be funded to examine all assetless insolvencies and reports should be prepared and made public as a matter of course.

3. TOR 1 Recent and emerging trends

As outlined in the introduction the dip in insolvencies (and related FEG payments and recoveries) during COVID and now a marked return to pre-covid insolvencies is broadly consistent with long-term drivers and patterns of corporate and business failures in Australia and overseas discussed earlier. In this regard record low interest rates, Jobkeeper, RBA liquidity measures and rent moratoriums temporarily improved the cash flow position of many business including undercapitalised struggling businesses. However with their cessation exits will increase as underlying firm level weaknesses manifest in increased levels of financial distress (see Kenney, La Cava & Rogers 2016).

Other long-established patterns of insolvency have not been fundamentally altered by covid. Industries with historically disproportionate high rates of business failures continue to be the epicentre of insolvencies largely because of longstanding, unaddressed problems with industry structure and business practice. For example the 2015 Senate Economic References Committee inquiry into insolvencies in the construction industry concluded (p. xix)

> *"The committee is particularly concerned at evidence that a culture has developed in sections of the industry in which some company directors consider compliance with the corporations law to be optional, because the consequences of non-compliance are so mild and the likelihood that unlawful conduct will be detected is so low. This culture is*

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reflected in the number of external administrator reports indicating possible breaches of civil and criminal misconduct by company directors in the construction industry. Over three thousand possible cases of civil misconduct and nearly 250 possible criminal offences under the Corporations Act 2001 were reported in a single year in the construction industry. This is a matter for serious concern. It suggests an industry in which company directors' contempt for the rule of law is becoming all too common."

It no surprise then that insolvencies in the building and construction industry are accelerating again as increases in interest rates and material costs make projects won on ultra-thin-margin, fixed-price contracts, unviable. This dynamic, in an industry defined by sub-contracting and labour hire, combined with a history of sharp practices such as phoenixing, will result in rapid cascading failures of undercapitalised, cash-flow sensitive businesses.

In hospitality, another high-risk industry, the dynamic of failure is created by low barriers to entry (which only amplifies problems of under capitalisation), excessive goodwill in valuations and intense price competition. This dynamic leads the normalisation of wage suppression and wage theft as strategies to keep businesses from going under or perpetuating unsustainable returns to investors. As such the ACTU is of the view that the regulatory and enforcement focus should be on these high-risk industries while the systemic drivers of insolvencies are addressed more holistically.

What is not well appreciated is that registrations of ABNs and proprietary companies has accelerated rapidly over the last two decades and now exceeds employment growth. This growth has occurred, in part, because workers who formerly would have been directly employed are now employed in assetless labour hire subsidiaries of complex corporate groups, are hired by labour hire providers at lower rates or coerced into business as (dependent) contractors by being obliged to operate as sole traders and apply for an ABN or register a proprietary company. When companies enter insolvency dependent contractors and, in some instances, labour hire providers become unsecured trade creditors.

4. TOR 2 Operation of the existing legislative and regulatory framework

Assessments of the operation of the existing legislative and regulatory framework on insolvency need to occur in the context described above – ie underlying drivers (under-capitalisation and poor skills), high risk industries, repeated failures by the same small cohort of individuals), costs

being externalised onto workers, creditors and the wider community, captured, muzzled or lax regulators and more recently a counter-productive public narrative encouraging entrepreneurship by destigmatising failure. This narrative has undermined public understanding that limited liability protection afforded to companies and their shareholders by statute is a privilege that confers major advantages over other businesse structures (ie sole traders and partnerships). The ACTU is opposed to any measures that make the existing regime more permissive by further de-risking failure and allowing directors and shareholders to externalise losses onto others without consequence. In this regard the previous government's Covid measures (temporary insolvency measures and increasing the statutory demand threshold) worked against earlier measures designed to increase personal/director accountability (personal property security , corporate accountability (by addressing FEG misuse and combating phoenixing) and liquidator accountability (Insolvency Law Reform Act).

While recently reversed, the decision by The Australian Accounting Standards Board in 2010 to allow Australian proprietary companies to choose to lodge much less detailed, non-comparable special purpose financial reports (SPFS). Introducing SPFS had the effect reduced auditing and accounting professional interaction with the directors of small proprietary companies. While it lasted this measure lessened transparency and made it more difficult to for creditors assess credit worthiness, reducing owner director accountability further and encouraging sharp practices (see Potter et al 2019). Anderson (2014) notes that employee and union access to timely and accurate financial statements, a feature of the German system where employee and union have mandated board roles, makes sudden insolvency and loss of entitlements less likely. In the absence of such governance arrangements the next best alternative is to ensure that all companies lodge annual reports (this is a requirement in the UK).

The small business insolvency reforms have had low take up because important pre-conditions on using safe harbours such as the business not having outstanding employee entitlements, which were designed to prevent abuses, has precluded their take up in most insolvencies. Loosening safe harbour criteria would encourage sharp practices and increase the likelihood of additional costs of insolvency being externalised on workers, unsecured creditors and the wider community. As such the focus now should be on the key regulators working together to test the application of the new laws, proactively asking for loopholes to be closed (for example mirroring automatic director disqualifications in personal bankruptcy in company insolvencies) and making more extensive use of existing powers (for example to prosecute directors who have breached their duties). Finally it is difficult to assess the impact of negating the use of ipso facto clauses. In theory more value should be preserved in insolvent firms as a result of their voiding but systemic problems with undercapitalization and director misconduct may mean the actual realized benefits of this change will be negligible.

5. **TOR 3** Potential areas of reform

Preference of Claims – At a conceptual level the ACTU strongly supports the principle that employees with entitlements should be first ranked and we oppose actions by creditors to recover goods or money that works against workers being paid in full. As outlined earlier the growth in dependent contracting and labour hire have effectively denied workers ongoing access to many entitlements they had as direct employees. In insolvencies dependent contractors become unsecured creditors while the employees of assetless internal labour hire subsidiaries are forced to fall back on the Federal Entitlements Guarantee (FEG). Employees of external labour hire providers who become an unsecured creditors in an insolvency face the real prospect of the provider also failing. Given the low recovery rates of FEG payments and outstanding tax liabilities there is also a strong case that industry be levied to cover the costs of the FEG or fees to register proprietary companies be increased to fund the FEG. Inherent conflicts in receiverships justifies their abolition, or failing that, the public appointment of receivers and their supervision by theCommonwealth company insolvency service.

Corporate Trusts and Trustees – in relation to insolvencies the ACTU supports assessing the conduct of corporate trusts and corporate trustees using the same principles and test applied to directors and officers.

Safe Harbours – For the reasons outlined in the preceding section the ACTU is opposed to making insolvencies more permissive by weakening the criteria that allow directors of distressed companies to seek 'safe harbour' while they attempt a rescue.

6. **TOR 4** Supporting business access to corporate turnaround

The ACTU does not support making the insolvency system more permissive by lessening the consequences of failure. Once a company is in administration or liquidation successful turnarounds are the exception rather than the rule. Longstanding trends in Australia along with Australian and international research on insolvencies do not support the 'honest failure' and 'second chance' narratives deployed to justify making the system more forgiving. Instead the research suggests that attempts to use insolvency system 'reforms' to drive entrepreneurship and innovation is profoundly misguided and will lead to counterproductive and perverse outcomes. Australian research highlights the causal pathway that ends in small business failure invariably starts with a lack of capital and poor levels of financial literacy (Campo & Barnes 2017, Mazzarol, Reboud & Clark 2015). These studies found a significant proportion of Australian SME

owner/managers did not understand how to read financial statements or how to conduct a basic break-even analysis (which has implications for pricing, profitability and at some point solvency). Their research also reveals that this lack of basic understanding of business financial concepts is a key causal driver in not keeping basic business records. This in turn leads to problems with cash flow management and making early calls about business solvency/viability.

Past initiatives to reduce financial reporting requirements for proprietary companies have only worsened the insolvency problem. As Mazzarol, Reboud and Clark (2015) show, financial reporting requirements creates a virtuous circle for business:

> *"In most advanced economies the requirement for SMEs to keep good financial records, and the obligation to do so for taxation compliance establishes their relationship with professional accountants and bookkeepers (Sian and Roberts, 2009). As the size and complexity of the business grows so too does the level of formality and sophistication in the financial management practices (Stafanitisis, Fafaliou and Hassid, 2013). Where owner-managers have greater skills and knowledge of the accounting and financial management processes they are more likely to generate financial reports and use them to make informed decisions (Van Auken and Carraher, 2013).*

Notwithstanding this wider evidence that detailed reporting improves business survival, Australia progressively loosened financial reporting requirements to the point that the Australian Accounting Standards Board noted in 2018 "The availability of (Special Purpose Financial statements) as a public lodgement option is unique to Australia – no other jurisdiction permits companies to publicly lodge financial statements on the basis of a subset of accounting standards and requirements determined by the entity itself". Higher quality financial reports will also help combat self-dealing (a contributor to insolvencies in proprietary companies with a single director).

In the ACTU's view a more productive approach involves the Commonwealth, in conjunction with the States, vetting and supporting aspiring business operators before and at the point of company registration or structure creation. Vetting would focuses on assessing knowledge of basic business concepts and evidence of business planning (including adequate capital adequacy). Introducing substantive minimum capital requirements for proprietary companies would also encourage systematic business planning and decisions not to proceed where prospects from the outset are challenging.

In addition, as evidenced during the Royal Commission into Banking, Superannuation and Financial Services, franchising inquiries and the 7 eleven wage theft investigations many former

employees use large redundancy packages to buy unviable franchises and small businesses. Better and more extensive advice at the point of purchase would allow relatively unsophisticated or inexperienced aspiring prospective business operators to better assess business opportunities presented by franchisors and parties selling businesses as 'going' concerns. As the ACCC website notes buying into a franchise does not guarantee success…. "Franchisees … take on the financial risk of the business. This could mean having no income if the business is unprofitable, or even being unable to cover the costs of running the business."

7. TOR 5 Role of Insolvency Practitioners

There are long standing issues with use of private insolvency practitioners in a system with overarching public interest objectives. These criticisms relate to the ability of directors to appoint preferred administrators and liquidators. Others have noted that voluntary administration is not a public process and directors exploit this weakness in the system to appoint their preferred administrators who are not inclined to report or disclosure director breaches. Conversely receivers appointed by individual creditors are criticised for being ruthlessly focused on the interests of their client at the expense of employees and other creditors. Finally, while the cost of administrating assetless failures are partly covered by the taxpayer via the Assetless Administration Fund (AAF) the cost of sustaining the insolvency industry has largely been shifted onto employees and creditors of less distressed but still insolvent companies. This results in longer and more expensive administrations and liquidations. Others have noted this cost shifting dynamic reduces the, albeit, small chance of turnarounds. As such the ACTU supports the creation of a Commonwealth company insolvency service that employs insolvency practitioners and oversees both administrations and liquidations. In this regard we note evidence already presented to the committee by others:

> *"The extent to which insolvency practitioners should continue to be the frontline investigators of insolvent companies, as stated by ASIC in its submission to this inquiry, is an important question for the integrity and efficacy of the insolvency system. In short, we say that we have an insolvency system that sets unrealistic and unachievable goals in a system that cannot afford to pay for the work that is currently required. We say that a greater role for the state is needed to address this gap. This is recognised in many other countries, including the UK, Singapore and New Zealand, with a government liquidator's office. It's been recognised here, in Australia, for more than 100 years in personal insolvency with the government bankruptcy trustee's office." Harris Hansard 13 December 2022 p38*

A Commonwealth Company Insolvency Service would complement work of the Bankruptcy Trustee. For this reason, it is likely that administrations, liquidations and business-related bankruptcies would become more coordinated and efficient. Although abolishing floating charge receiverships is preferable, the creation of such a service would allow the appointment of

disinterested receivers and allow the public examination of companies where individual creditors holding floating charges are concerned about default.

8. TOR 6 Role of Government Agencies

Consistent with the discussion thus far the ACTU strongly supports the expanded role of existing and new public agencies which are empowered to pursue public interest objectives in relation to insolvency and business-related bankruptcy. We recommend the creation of a Commonwealth Company Insolvency Service and increasing funding support for business advisory services to ensure new companies start out on the right foot.

As outlined earlier the cost of company failures is being externalised on employees, creditors and the community. The FEG scheme while covering some lost employee entitlements is becoming increasingly costly (notwithstanding the Covid dip in failures) and is only recovering a small proportion of paid entitlements from insolvent companies. In addition business entities are responsible for unpaid tax debts roughly equivalent to the current budget deficit. It is noted that the previous Government defunded ASIC while expanding its workload (for example director IDs). Public service staffing caps have resulted in loss of capability and less comprehensive oversight of companies. Problems with regulator oversight have been exacerbated by the lowering of financial reporting standards and the more permissive attitude to insolvency and bankruptcy along with a marked reluctance to close longstanding loopholes in the corporations law (for example, not automatically disqualifying directors in the same manner as when individuals made bankrupt). Director disqualification and banning of associates would materially reduce repeat director failure rates. ASIC has a longstanding reputation of not prosecuting breaches of directors' duties with sufficient vigour. Extra resources also need to be committed to building out inter-agency cooperation with the ATO, AFSA, Austrac, FWO, Federal Police, Border Force (amongst others) in order to more closely monitor high risk industries and combat related sharp practices such as phoenixing, modern slavery abuses, tax avoidance and wage theft.

9. TOR 7 Any related insolvency matters

The ACTU recommends increasing minimum company capitalisation requirements because it will; (a) encourage prospective business operators to better plan and assess the viability of a business before proceeding to incorporation and (b) discourage the creation of deliberately complex and opaque corporate groups that include assetless subsidiaries.

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