THE RISE OF THE 'WALKING DEAD': COMPANIES IN DISTRESS AND AVOIDING THE PITFALLS

Key trends, reasons and warning signs.

Research Report

THE POWER OF BEING UNDERSTOOD
AUDIT | TAX | CONSULTING

RSM

ABOUT US

We are a full service national accounting firm delivering expert corporate financial and advisory accounting services to clients across diverse industry sectors. We boast a national network of 29 offices which, combined with over 90 years' experience, has helped us develop an extensive understanding of Australian business trends and conditions.

Our team of Restructuring & Recovery professionals are located in Albury, Brisbane, Canberra, Melbourne, Perth, Sydney and Wagga Wagga that can undertake a wide range of insolvency services appointments.

Our valued client relationships and connections include:

- Corporations in financial difficulty that need assistance in reorganising their affairs
- Directors and business proprietors who have a personal financial exposure
- Bankers, other financial institutions, and government agencies that have concerns about the financial health of a borrower
- Lawyers seeking specialised business recovery services for their clients
- Other accountants and consultants seeking specialised business recovery services for their clients

OVERVIEW

After last year's announcement that the ATO is getting tougher on tax collection, many Australian businesses that were barely surviving before are apparently edging ever closer to insolvency.

This is backed up by ASIC statistics that show that, in the last year alone, there has been a national increase in the amount of official liquidations by 31.9%, with the largest increases in NSW, VIC, and WA.

In the past, the outstanding tax debt was generally around $300,000 before the ATO pursued recovery actions or wind-up notices; that appears to have reduced substantially, with debts now as low as $60,000 having been the subject of recovery action by the ATO. A rising number of companies continue to survive, but with a lack of capital are unable to grow. They are more vulnerable than ever to market changes, which can inevitably lead to closure. These businesses are poignantly referred to as the 'walking dead'.

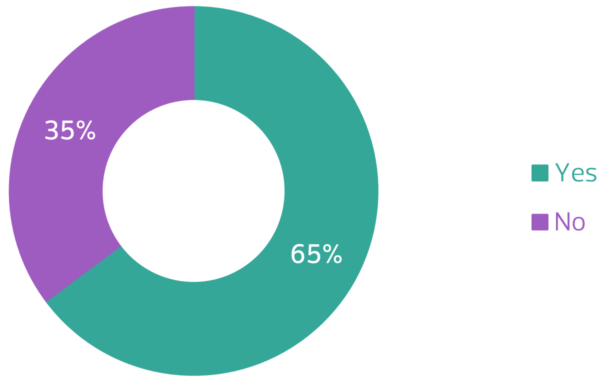
To understand more about this phenomenon, and to consider ways to alleviate the problem, we surveyed over 1,500 Australian business owners, consultants, and directors from a cross section of business sectors.

We asked them for their perceptions of the trend, with the following three questions:

1. Have you noticed an increase in 'walking dead 'companies in your industry?
2. In your opinion, what are the primary causes of this growing trend in Australia?
3. What are the warning signs that a company may become one of the 'walking dead'?

KEY SURVEY INSIGHTS

QUESTION ONE: HAVE YOU NOTICED AN INCREASE IN 'WALKING DEAD' COMPANIES IN YOUR INDUSTRY?



Over two thirds of respondents (64.8%) had noticed an increase in the 'walking dead' in their industry.

> "I own businesses in three different industries and yes I have noticed [an increase in] companies living on borrowed time."
> Owner/CEO, Import & Export (VIC)

Only around a third of respondents said they hadn't noticed the increase in their industry. Some attributed this however to the nature of their industry. For example one respondent said,

> "I haven't noticed more 'walking dead' really. Retail is an industry where many people shut up shop regularly. "
> Consultant, Retail (NSW)

Even some respondents who hadn't noticed it yet themselves were keen to point out that they recognised that the problem exists. They highlighted that it is especially prevalent in start-ups and industries with small one-man operations.

> "I am seeing a few companies struggle to make it through the 'valley of death' in startup land."
> Founder, Management Consulting (ACT)

Some respondents offered possible reasons (beyond the ATO getting tougher) for the growing trend. They argue, it's due to the rising obligations around administrative costs of taxation, insurance, legal protection, and the necessity of having online technology. This is a topic we cover in more depth in Question Two.

Just over half of the respondents who had seen an increase in liquidations linked the problem directly to the harsher collection requirements of the ATO.

> "There is no doubt the ATO has recently started cracking down on companies that are behind in their tax obligations."
> Senior MD, Accounting (VIC)

Respondents generally recognised the ATO's new and more stringent approach as being "more aggressive in its recovery and less obliging in making payment arrangements." Some even consider the policy as "ruthless" and a direct attack on small businesses. These respondents argue that companies on accruals basis will be forced to pay GST in advance of receipt. This in turn causes more cash flow problems for those companies with long term debtors.

THE BIG PICTURE

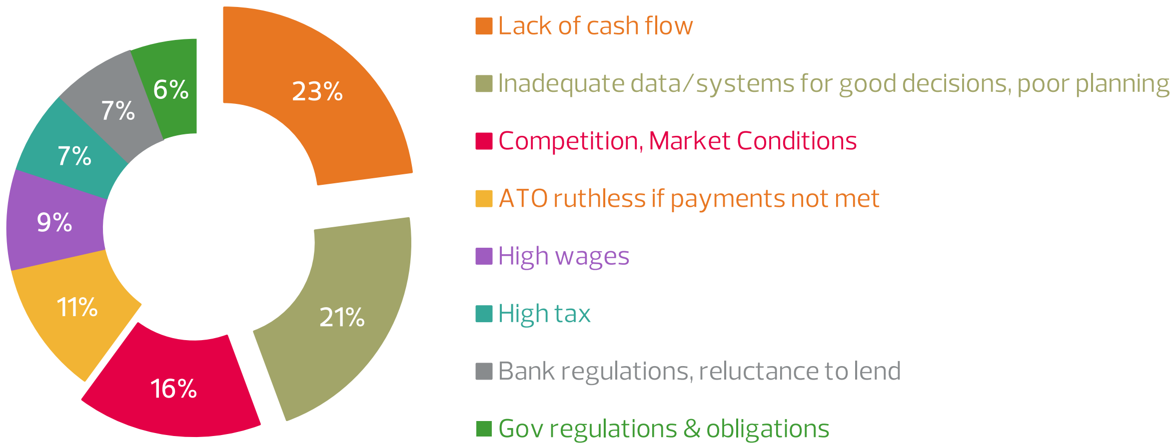
The ATO is owed a staggering $34 billion, which is the equivalent of a whole year's budget deficit.

It has only reduced the outstanding debt by $1 billion in the last 12 months. However, not surprisingly, it is now aiming to make more significant recoveries and it is likely the level of recovery activity will remain constant for the next 18 months to 2 years.

Businesses better get used to it – In 2014 there were 2800 companies wound up nationally. In 2015 this figure jumped to 3694. There is a clear message that the ATO wants its money, and is prepared to take action to recover it. The ATO are no longer prepared to be considered the funder of small business in Australia.

The low interest rate environment is effectively a 'time bomb' for companies with higher-than-average debt levels. When rates rise, which is inevitable at some stage in the near future, these businesses may start to struggle, and the ATO may start to focus their collection efforts on them. In addition, in a low growth environment it becomes increasingly hard for businesses with high debt levels to make enough profit to service those debts.

QUESTION TWO: WHAT ARE THE PRIMARY CAUSES OF THIS GROWING TREND IN AUSTRALIA?



Lack of cash flow is the primary reason for companies risking insolvency.

23% of respondents suggested that lack of cash flow is the primary cause of the growing trend of business insolvencies.

So, rather than pointing the finger directly at the ATO for tightening its policy, these respondents recognise that business owners need to take active steps to minimise the risk.

> "Poor company executives and board members, who do not have enough experience and continually chase contracts that do not provide enough long-term cash flow."
> Owner/Founder, IT Services (ACT)

Many respondents were keen to put the onus on business owners to tackle the problem by educating themselves to minimise the risks and vulnerabilities in their business. Many suggested it was an issue of financial literacy, a skill they argue is lacking among Australian small to medium business owners. More specifically, better budgeting and cash flow management techniques are seen as crucial to a business's survival, particularly when market conditions change.

There was also recognition that the regulators and banks could be doing more to ease cash flow problems as additional working capital is becoming more difficult to attain.

Another major contributor to the problem is inadequate systems for making informed decisions.

Companies working without a clear picture of their state of health are very vulnerable: Over one in five (21%) of respondents suggested that the rising insolvency rate of companies was mainly due to inadequate data and systems leading to poor decision making, and substandard financial records resulting in uninformed planning.

> "Inadequate data to make decisions – daily, weekly, and monthly. Many of the SMEs I talk to have no idea of the status of their P&L and Balance Sheet. They are working in the dark. Their systems are non-existent."
> Owner, Retail (ACT)

In some cases, the ability of directors to adequately plan for the future was called into question; some were accused of sticking their heads in the sand about ATO payment issues. However, respondents suggested that pushing towards online accounting systems would help the 'walking dead' to monitor their profitability in real time, not once a problem arises. Being pro-active in the short-term is key for cash-flow success in the long-term.

Other reasons for the rising insolvency rate are market conditions, competitiveness, high taxes, high wages, and stricter regulators

Several other reasons were highlighted for the increasing number of Australian business closures.

These include heightened competitiveness in the market (15.7% of respondents) and higher wages (8.6%) making it harder for companies to survive and grow. Other respondents (7.1%) mentioned high taxes, compounded by stringent collection measures, diminish the incentives for a business to grow, as with growth comes higher tax payments.

Banks and regulators are also reacting, not lending to companies unless they are supported by real estate. As respondents pointed out, global banking regulations are tightening and within the next 18 months we will see the 'walking dead' increase even more.

THE BIG PICTURE

While cash is indeed 'king', it should be remembered that *a lack of cash flow is often a symptom of far deeper and more complex problems.*

Principally, cash flow problems emanate from a decline in profitability or failing to plan adequately for growth. Failure to plan is, indeed, planning to fail, and it often results in an immediate cash flow shortage.

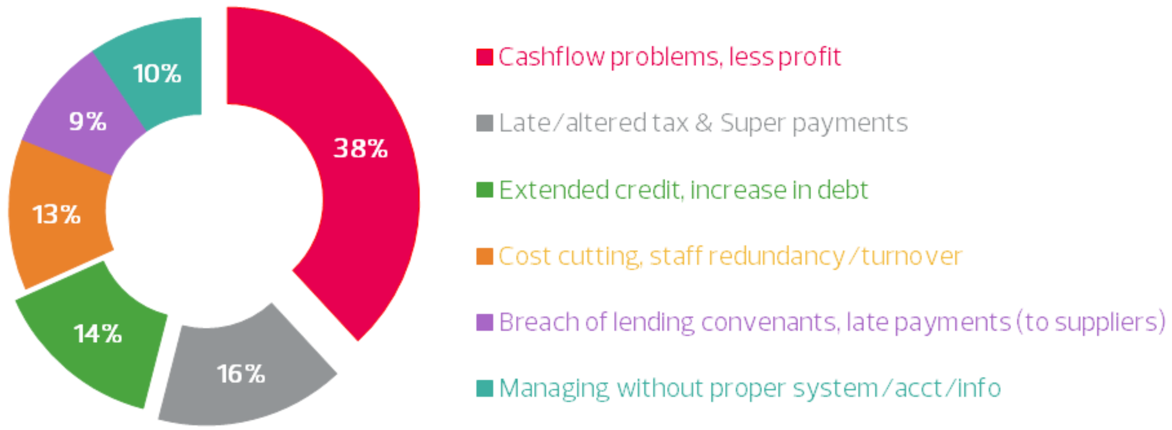
This is reflected in almost half of the respondents identifying poor planning, systems, and cash flow as the main reasons for the increase in company liquidations.

These reasons are all within the control of any organisation and are therefore reversible.

The other causes cited by respondents such as market competition and government regulations are part of the operating environment that organisations must live with, and are therefore largely out of their control.

Companies therefore need to focus on what they can control: utilising up to date information and accounting systems, and preparing business plans, budgets, and cash flow forecasts that fully and adequately provide a basis for future operations. Directors must ensure their businesses stick to these plans or be nimble enough to adapt to changing environments.

QUESTION THREE: WHAT ARE THE WARNING SIGNS THAT A COMPANY MAY BE ONE OF THE 'WALKING DEAD'?



Virtually all the key indicators that a company is one of the 'walking dead' relate to cash flow.

Almost 40% of respondents directly referred to cash flow shortage as the overarching indicator of 'walking dead' status:

> "On many occasions the taxpayer has to borrow to pay taxes as their debtors are slow in paying. In fact we see many go into insolvency being owed a considerable sum by debtors for which they have had to pay GST. Further, the taxpayer still had to meet overheads such as wages and PAYG with no cash flow at times."

Many others commented on the effects of poor cash flow on other aspects of the business, such as late payment to suppliers, extended credit, and an increase in debt:

> "Extension of creditor' terms; rising overdrafts; and contracting margins due to interest on borrowed funds."
> Senior Partner, Accounting (NSW)

Late tax and super payments are another key indicator of cash flow problems, highlighted by 15.9% of respondents:

> "They miss their tax obligations as their business needs the cash to run."
> Managing Director, IT Services (ACT)

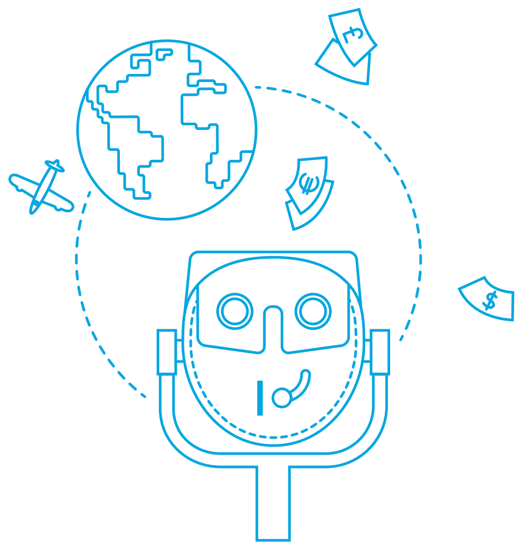
12.7% of respondents pointed out that such businesses are often forced to start cost cutting, with the primary cuts coming in the form of staff cuts with the owner working more hours. Respondents went on to say that this leads to a high staff turnover, which in turn piles even more pressure and consequence onto both the owner and managers' shoulders.

> "The company constantly restructuring/changing model and market , staff cuts to increase 'efficiency', leading to high staff turnover."
> Owner/CEO, Import & Export (VIC)

It should be pointed out that these indicators could equally be a sign of a struggling company trying to address its cash flow warning signs.

Poor systems and data access was also cited as both a key warning sign of 'walking dead' companies AND a cause of their condition (see question 2). Around 9.5% of respondents said that companies without the right accounting or information systems in place end up 'in the dark' and in peril:

> "Late or non existent BAS lodgement, a lack of financial reporting at all, and a business owner who is too busy to stop and review business performance."
> Director/Accounting (NSW)



THE BIG PICTURE

'Walking dead' status does not appear overnight; there are generally visible warning signs.

You need to be proactive and introduce good debtor control systems that can recognise these signs early on and allow you to act upon them as necessary.

A particularly common precursor to trouble is a rising number of days outstanding for payments. This is especially problematic when larger customers are stalling; it may be a sign that they are in trouble and, if this is the case, the late payments are likely to get worse.

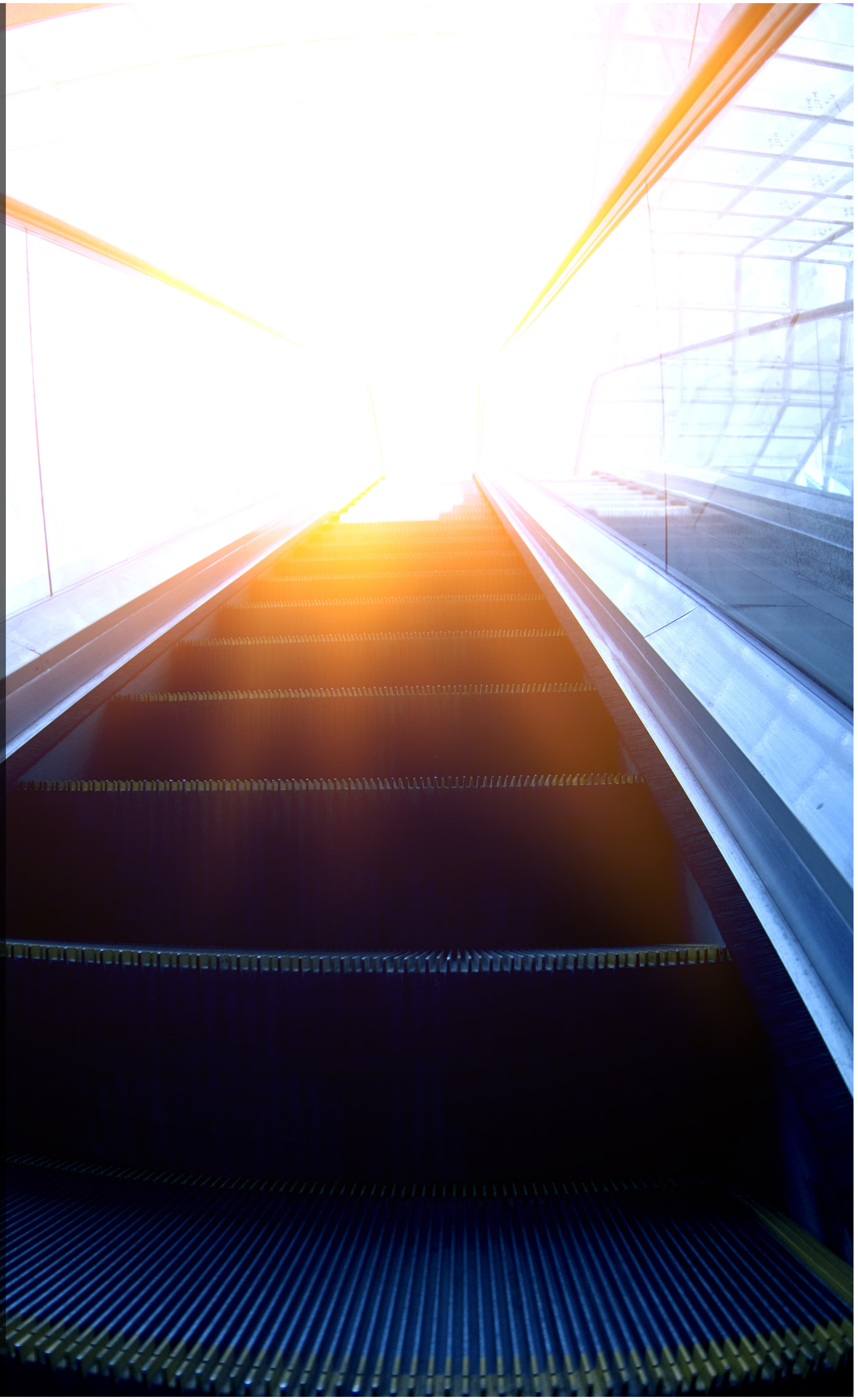
Just because your client has been with you for 20 years doesn't mean that they are any more secure – in fact it can lull you into a false sense of security.

There is an old saying when it comes to collecting debts: "The squeaky wheel gets the most oil". *With good systems in place and good reminders, you can be the 'squeaky one' who gets paid first.*

Another key indicator of problems is falling profit margins. When this happens, you need to know if the reasons for the fall are the result of one-off factors, cyclical or permanent.

Businesses that have not yet introduced modern cloud-based systems like Xero may also be more at risk from inaccurate or delayed management information.

To recognise these warning signs, it's important that the owner works ***on*** the business, and not just ***in*** the business. That is, they should be focusing on the direction of the company, not just the day-to-day delivery of services.



SUMMARY

Australian businesses need to take pro-active steps to avoid 'walking dead' status

The ATO's crackdown on debt has been met with some criticism as an 'attack' on small businesses. Such criticism is unfair and deflects attention away from the issue. That is, that a large number of small business fail to meet their tax obligations. They often default to using the ATO as a pseudo lender of last resort.

Whatever your opinion on the matter, there is no sign of a softening in approach from the ATO. Over the next 18-24 months we expect the level of recovery activity to remain constant. It is highly likely, therefore, that the number of 'walking dead' companies will continue to rise.

Research shows that the following industries in particular are most impacted by the tax debt issue: financial and insurance services, construction, professional/scientific services, agriculture/forestry/fishing. But it is likely that all industries will be affected over the next two years.

Many businesses are essentially 'time bombs' – with high debt in a low interest environment, when the rates rise back to the much higher long-term norm over the next couple of years, what happens?

Without adequate systems in place to flag problems in a timely and accurate manner, many Australian businesses are also working 'in the dark'. This is extremely risky for cash flow and profitability, and can lead to problems with creditors and higher debt levels with the ATO and others.

Fortunately, there are steps that businesses can take to protect themselves against exposure to this problem. Cash flow, systems, and planning mechanisms can all be improved if there is an appetite in the business to make some simple changes.

These steps are all within the control of any business owner and can help to protect the company against exposure to the ATO's harsher policies, no matter what the influence of the market or other operating environment factors.

Where do you start?

One of the main challenges for businesses with cash flow problems, outdated systems, or planning inadequacies is knowing where to start to put things right.

RSM can assist in fully understanding a company's exposure to the risks. Allowing business owners to take steps to alleviate the risk and, in turn, reduce the likelihood that they are flagged by the ATO and become a 'walking dead' entity.

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