Australian Government
Productivity Commission

Business Set-up, Transfer and Closure

Productivity Commission
Draft Report

May 2015

This is a draft report prepared for further public consultation and input.
The Commission will finalise its report after these processes have taken place.

An appropriate reference for this publication is:

Productivity Commission 2015, *Business Set-up, Transfer and Closure*, Draft Report, Canberra.

Publications enquiries

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The Productivity Commission

The Productivity Commission is the Australian Government's independent research and advisory body on a range of economic, social and environmental issues affecting the welfare of Australians. Its role, expressed most simply, is to help governments make better policies, in the long term interest of the Australian community.

The Commission's independence is underpinned by an Act of Parliament. Its processes and outputs are open to public scrutiny and are driven by concern for the wellbeing of the community as a whole.

Further information on the Productivity Commission can be obtained from the Commission's website (www.pc.gov.au).

Opportunity for further comment

You are invited to examine this draft and comment on it by written submission to the Productivity Commission, preferably in electronic format, by **3 July 2015**. Further information on how to provide a submission is included on the inquiry website http://www.pc.gov.au/projects/inquiry/business.

The final report will be prepared after further submissions have been received and public hearings have been held, and will be forwarded to the Australian Government by the end of August 2015.

Public hearing dates and venues

Location	Date	Venue
Melbourne	Monday 22 June 2015	Productivity Commission L12, 530 Collins Street
Canberra	Wednesday 24 June 2015	Productivity Commission L2, 15 Moore Street
Sydney	Tuesday 30 June 2015	SMC Conference & Function Centre Corinthian Room 66 Goulburn Street

Commissioners

For the purposes of this inquiry and draft report, in accordance with section 40 of the *Productivity Commission Act 1998* the powers of the Productivity Commission have been exercised by:

Warren Mundy	Presiding Commissioner
Melinda Cilento	Commissioner

Terms of reference

I, Joseph Benedict Hockey, Treasurer, pursuant to Parts 2 and 3 of the *Productivity Commission Act 1998*, hereby request that the Productivity Commission (Commission) undertake an inquiry into barriers to business entries and exits and identify options for reducing these barriers where appropriate, in order to drive efficiency and economic growth in the Australian economy.

Background

Firm entry and exit plays an important role in fostering innovation, competition, and thereby driving productivity and economic growth. Competition from new firms, or even the threat of potential entry, forces existing firms to be more efficient. The exit of inefficient firms can provide for greater allocative efficiency as their former resources can be put to higher value uses.

Certain barriers to entry and exit have the potential to hinder the efficient operation of markets, with negative consequences for economic growth. Barriers to entry and exit can be a function of market structure, government regulation, industry specific sunk costs or geography. Cultural appetite for risk is also an important determinant of the level of business entry and exit in an economy.

Business insolvency also results in losses to equity and debt holders, and to employees. Different approaches to managing insolvency can affect the efficient provision of finance and labour.

Scope of the Inquiry

The Commission is to conduct a broad ranging investigation into barriers to business entries and exits and how or where it might be efficiency-enhancing to reduce such barriers. In undertaking this inquiry, the Commission is to investigate, analyse and propose recommendations on the following:

1. The nature and scale/extent of barriers to entry and exit that currently exist for firms and their impact on economic performance.
    (a) Consideration could also be given to the variance in entry and exit rates, for example, between industries, locations, or firm size.

2. Identify appropriate options for reducing these entry and exit barriers, including, but not limited to, advice on the potential impacts of:
   (a) The regulation of product and service markets;
   (b) Transfers and subsidies to businesses, including import barriers;
   (c) Regulations affecting the ease of starting, operationalising or closing a business;
   (d) Time spent on and cost of complying or dealing with government regulation, licensing and bureaucracy; and
   (e) The personal/corporate insolvency regimes on business exits.

Process

The Commission is to undertake an appropriate public consultation process, inviting public submissions and releasing a draft report to the public. A final report should be provided to the Government within nine months of receipt of the reference.

J.B. HOCKEY
Treasurer

[20 November 2014]

Contents

Abbreviations and explanations

Abbreviations

ABA	Australian Bankers' Association
ABN	Australian Business Number
ABR	Australian Business Register
ABS	Australian Bureau of Statistics
ACCC	Australian Competition and Consumer Commission
ACCI	Australian Chamber of Commerce and Industry
ACN	Australian Company Number
ADI	authorised deposit-taking institution
AFSA	Australian Financial Security Authority
APRA	Australian Prudential Regulation Authority
ARITA	Australian Restructuring Insolvency and Turnaround Association
ASIC	Australian Securities and Investments Commission
ASX	Australian Securities Exchange
ATO	Australian Tax Office
AUSTRAC	Australian Transaction Reports and Analysis Centre
BAS	business activity statement
CAMAC	Corporations and Markets Advisory Committee
CAUSEE	Comprehensive Australian Study of Entrepreneurial Emergence
CCIQ	Chamber of Commerce and Industry Queensland
CGT	capital gains tax
COAG	Council of Australian Governments
FSI	Financial System Inquiry
GDP	gross domestic product
GFC	global financial crisis
GST	goods and services tax
IPO	initial public offering

OECD	Organisation for Economic Co-operation and Development
PC	Productivity Commission
RBA	Reserve Bank of Australia
SME	small and medium-sized enterprise
TFN	tax file number

Explanations

Billion	The convention used for a billion is a thousand million (10^9).

OVERVIEW

Key points

- Businesses are set-up for a variety of reasons and in any one year there is a churn of entries and exits in Australia that is comparable with other countries. Most businesses are small and a very low proportion are innovative, producing a product or service new to Australian or international markets. The propensity to be innovative is highest amongst larger businesses.
- While it is generally relatively easy to start a business, a number of longstanding issues with specific regulatory requirements and regulator engagement and funding remain unaddressed and are making new business entry unnecessarily complex or costly.
- Some new business models — particularly those that exploit digital technology to make better use of information — are challenging existing regulatory arrangements or causing others to operate in regulatory grey areas. Regulators should have the capacity to exempt businesses, for a fixed period, from particular regulatory requirements where these deter entry but exemption does not threaten consumer, public health and safety, or environmental outcomes.
- Government assistance to business set-ups should not be directed at particular business models, technologies, sectors or locations — criteria based on desired outcomes (such as technology transfer and spillovers) with matching private sector investment, are less likely to distort incentives and behaviours, particularly in a rapidly evolving environment. Any assistance should focus on those areas where there are economy-wide net benefits, and in the absence of a business set-up, there would be a justifiable need for other forms of government assistance.
- Access to finance is generally not a significant barrier to business set-up.
  - New debt financing platforms, such as peer-to-peer lending, are helping to fill the gap in unsecured debt finance available from the major financial institutions. The voluntary participation by lenders in comprehensive credit reporting should be reviewed.
  - A two-tier regulatory structure should be introduced for crowd-sourced equity to balance the financing needs of business against the risk preferences of different types of investors.
- Most businesses are closed or transferred without financial failure. Governments' role in such situations should be limited to provision of clear guidelines for businesses, associations and advisers on exit and succession planning, and ensuring government processes are timely.
- While some specific reforms to Australia's corporate insolvency regime are warranted, a wholesale change to the system, such as the adoption of the United States 'chapter 11' framework, is not justified.
  - Formal restructuring of companies through voluntary administration should be enabled as an option for when a company may become, but is not yet, insolvent.
  - There should be provision for a 'safe harbour' to allow company directors to explore restructuring options without liability for insolvent trading.
  - A simplified liquidation process should be introduced to reduce the time and expense of winding up businesses with little or no recoverable assets.
  - All directors should be required to obtain a director identification number to enable the easier detection of disqualified or fraudulent directors.
- The default exclusion period and associated restrictions applying to bankrupts in relation to access to finance, employment (including being a company director) and overseas travel should be reduced from 3 years to 1 year, with the trustee and courts retaining the power to extend this period where necessary to prevent abuse of the bankruptcy process.

Overview

An evolving and expanding stock of businesses is essential for a growing economy. The motives and expectations that underpin starting a business are many and varied — at one end of the spectrum are businesses that are highly innovative and have ambitious growth expectations; at the other extreme are those businesses that primarily seek to provide stable employment and income for the owners. Not all new businesses will succeed or survive, but many do, and go on to motivate and enable innovation and growth in other parts of the community. For those businesses that fail, it is important to ensure that the assets of the business — physical, financial and human — are able to be quickly deployed elsewhere in the economy, and that prospective new business approaches are not unnecessarily discouraged.

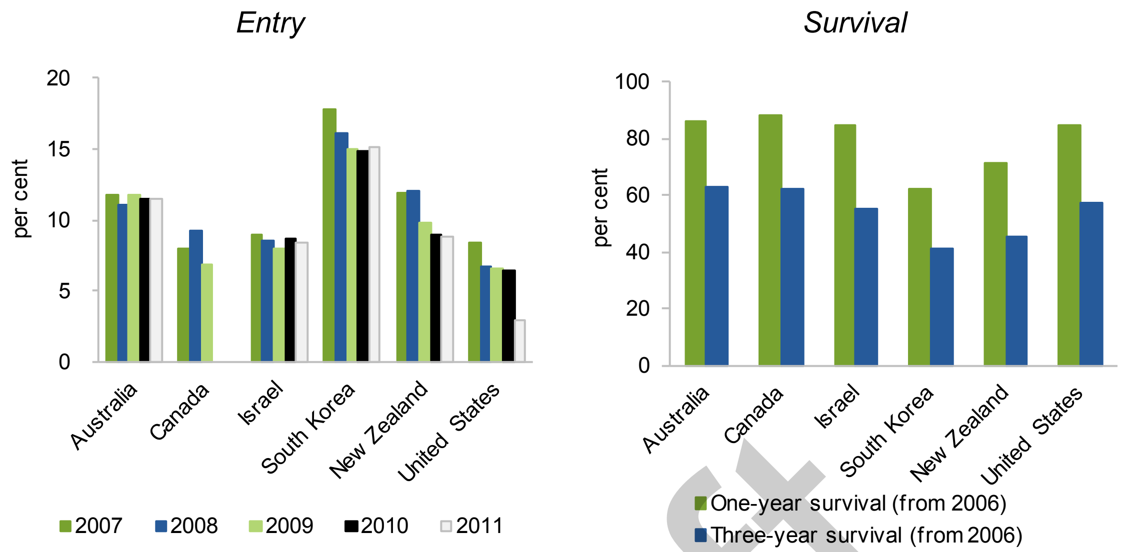
This inquiry is about the impediments faced by those setting up, transferring or closing businesses in Australia. Such impediments arise, for example, from regulation, from the misguided participation of governments in markets, from industry-specific arrangements and interactions, or from broad cultural features (such as attitudes to entrepreneurialism or to business restructuring). The Commission has been asked to undertake a broad ranging investigation into these impediments and recommend ways to remove or reduce them in order to improve the overall efficiency and effectiveness of market operations.

The business landscape is evolving

There are around 2.6 million businesses registered as operating in Australia. Variation in the rate of business entry and exits is low year to year (for all business size groups). Australia has relatively high business entry rates when compared with other countries, including the United States, although there was a dip in entry rates in Australia and other countries following the global financial crisis. Australia's business survival rates are comparable with those in the Unites States and Canada and above those of New Zealand and South Korea (figure 1).

Sectorally, there has been a net decrease in the number of primary production businesses each year recently, a net increase in the number of health care and social assistance businesses and small year to year fluctuations in other sectors. These aggregate and sectoral changes ignore any growth in the size of businesses and do not, in themselves, suggest a need for government policy action.

Figure 1 **Business entry and survival rates in Australia and overseas[a]**



[a] Entry rates are for employing businesses only which, in Australia's case, means the reported rate is slightly below the total business entry rate.

The vast majority (over 90 per cent) of new businesses are micro-businesses with few (less than four) or no employees. Most business owners are male, but female owners are becoming more prevalent in new businesses set-up. The median age of business owners (at 47 years) is older than the general workforce and is increasing faster. Many businesses are started to provide employment for the owner or their family, to satisfy lifestyle choices, to provide services to a community sector or to raise funds for a specified purpose. Such businesses are not necessarily innovative, nor is rapid growth necessarily sought. For example, employment growth over the past four years in small businesses has been flat, considerably below that in medium and large businesses (15 per cent).

A small group are innovative

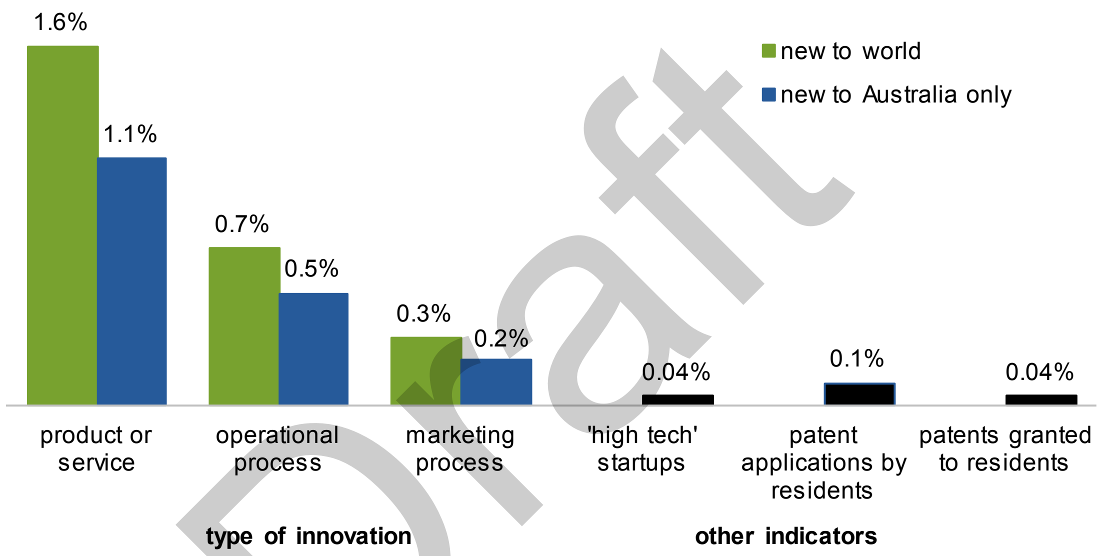
Around 1-2 per cent of businesses are innovative in terms of delivering a product, process, marketing and/or organisation approach that is new to the Australian or international market (figure 2) (compared with around 14 per cent that reported adopting a product, process and/or approach that is 'innovative' for their business but not necessarily for other businesses). Although data limits cross-country comparisons, innovation rates by Australian businesses appear to be in line with some other OECD countries such as France and New Zealand. Across all OECD countries, 'high growth' innovative businesses typically account for around 2-4 per cent of all businesses.

Small businesses (those with fewer than 20 employees) are far less likely to engage in innovative activity than larger businesses. An estimated 1 per cent of small businesses introduced an innovative product or service that was 'new to Australia' in 2012-13, compared with 14 per cent of large businesses.

Those businesses innovating in an Australian or international market have high growth potential, are more likely to seek external finance, and have been shown to make a significant contribution to economic growth, increasing productivity and employment creation.

Figure 2 **Innovative business activity**

Per cent of all actively trading Australian businesses in 2012-13



More businesses are being started under company and trust structures

Businesses in Australia are generally formed under one of four structures — sole traders, partnerships, companies and trusts. The ownership form selected is usually based on what form best suits the nature or needs of the new business at set-up and its expected financial situation — in particular, the likely need for debt and equity and plans for redistributing any business profits. Minimising tax paid (given the tax treatment of different structures over the life of the business and on exit) and personal liability and asset protection are also important determinants of the chosen business ownership structure. Overall, partnership arrangements are becoming less commonly chosen structures for business establishment; company and trust arrangements are becoming more common. While most new entrants in recent years have formed as either sole traders or companies, many of these are established for a very limited time — in the case of companies for example, sometimes for the life of a single property development or when people are between full time jobs.

The Commission was advised that businesses sometimes set up more complicated structures than needed (such as layers of trusts and companies), as changing a business ownership structure can involve substantial costs, including capital gains tax. More complicated structures typically involve higher ongoing fees to professional advisors. The use of a particular ownership structure (such as a discretionary trust) in order to minimise tax paid by the business or its owners, potentially erodes the personal and/or corporate income tax base, creates a bias in business investment toward activities that generate low pre-tax returns (rather than high economic returns) and a distortion in the allocation of resources across the economy. The Commission considers that the tax system should, in principle, provide a consistent treatment of businesses, regardless of the chosen ownership structure. The incentives presented to businesses as a result of taxes that differ with business ownership structures are a consideration of the current White Paper on the Reform of Australia's Tax System.

Some new business models are challenging the existing regulatory arrangements

The emergence of new business models is a fundamental aspect of an innovative and growing economy. Some business models combine previously separate activities (such as tourism with access to nature reserves or the sale of specialty foods in mobile or temporary venues) but are not principally innovative. Others, particularly in recent years, draw on technology and/or the internet to deliver products and services in different ways, including by enabling the superior use of information — connecting information in new ways, turning physical products into digital products, aggregating fragmented information and matching supply with demand in new ways. These new models better meet some consumer needs (such as Uber transport services or PayPal facilities), improve choice, increase utilisation of existing capital/labour in a sector, and/or lower the prices at which goods and services are provided.

Where these new models are operating in existing markets, there is often an element of 'disruption' for established businesses (as they attempt to rapidly improve their product and maintain a customer base) and for regulators. While many new business models operate within the prevailing regulatory frameworks (such as online employment matching services), others are challenging regulatory arrangements or cause other businesses/individuals to operate in regulatory grey areas. For example, AirBnB may not be operating counter to any regulatory requirements but its model facilitates individuals offering accommodation that may not satisfy existing regulatory requirements. It is often in those sectors that have resisted competition reform (where existing caps, licence or regulatory requirements act as a barrier to competition) and/or have high economic rents (such as the personal lending sector) where new business models are most attracted and face the most barriers to setting up. Incumbents (or at least their representative bodies) often cite public health and safety standards prescribed by existing regulations or sector stability as reasons to restrict entry by new businesses.

One area where there appears to be pressure for regulatory changes to reduce barriers to new business models is the payment systems that underpin most transactions in the economy. Under the existing regulatory framework, for example, businesses that handle and temporarily store customer funds (such as those operating stored value accounts used in many tolled transport networks) must either: obtain an Australian Financial Services licence; be explicitly exempted from such requirements by regulators (as with pre-paid mobile phone accounts); be guaranteed by an authorised deposit–taking institution or government authority; or remain small with stored value holdings of less than $10 million and up to $1000 per client. Widely used stored value facilities may also be subject to prudential regulation (for example, PayPal). The Commission considers there is a need for an enhanced graduated regulatory framework with clear thresholds for payment systems, such that new business models that do not hold large amounts of funds can be regulated in a way that reflects the (often low) comparative risk posed to consumers and to financial system stability.

Alternative new payment approaches are largely unregulated in Australia. For some, such as Cabcharge payment instruments, the lack of regulation means their considerable market power is largely unchecked and access for new entrants is difficult. For digital currencies such as Bitcoin, the lack of regulation means that credibility of the digital currency relies on the businesses developing voluntary security and consumer protection measures. The Commission considers there is merit in bringing non-cash payment systems of significant size (in particular, the Cabcharge payment system) and digital currency businesses within the relevant regulatory frameworks.

Response to new business models needs to be flexible

Overly prescriptive or inflexible regulatory requirements can shield existing businesses from competition, impose unnecessarily high costs on new business entrants and therefore consumers, and hinder innovation and economic growth. Government and regulator responses to new business models are critical to their success.

The Commission considers that regulators need to be able to respond flexibly to new business models not previously contemplated that are challenging regulatory requirements. This could be achieved by giving regulators (or Ministers on advice from regulators) the capacity to provide fixed term exemptions to specific regulatory requirements that deter business entry but do not threaten consumer, public health and safety, or environmental outcomes (for example, because the desired outcome is being achieved through means other than that prescribed by regulations). Such exemptions would be disallowable instruments and subject to parliamentary scrutiny and public review prior to expiration. New regulatory frameworks and revisions to existing regulations should identify and focus on desired regulatory outcomes. Regulatory requirements necessary to address legitimate risks to the community should not be specific to a particular technology or business model, and should avoid placing unnecessary burdens on businesses — whether new or established.

Long standing regulatory issues remain unaddressed

There are many regulatory requirements and arrangements that relate to establishing or closing a business. Which regulations apply depends on a number of business-specific factors including the ownership structure of the business, the business location(s) and the product or service being supplied. Some regulatory requirements are necessary to achieve public policy objectives, such as public safety or fair trading. However, outcomes critically depend on the design, implementation and enforcement of regulations. The Commission and others have detailed in past reviews of regulation, a broad range of regulatory reforms that are likely to lead to better outcomes for the community. There is also still much work to be done to improve the engagement processes of many regulators and to ensure regulators are adequately funded. The emergence of new business models reinforces the importance of early and effective regulator engagement.

Some important regulatory reforms have occurred. For example, the states and territories have migrated their business licence information data into the national system (known as the Australian Business Licence Information Service) and the Australian Government created the infrastructure around the Australian Business Account as a single entry point for business interaction with government registration and compliance processes.

However, it is also apparent that, as highlighted in past reviews, there remain significant regulatory requirements that needlessly hinder the establishment and closing of businesses that governments — primarily state, territory and local governments — have yet to act on. Locational restrictions on pharmacies (the province of the Australian Government) and the growing and marketing of potatoes in Western Australia are two notable examples, although reforms in these areas have been recently mooted. At a local government level, many zoning and development assessment requirements remain unnecessarily interventionist, costly and time consuming.

The issue and renewal of licences is an area that many new (and established) businesses find particularly burdensome. While it is unlikely to deter the set-up of most businesses, the paperwork, inspections and interactions with regulators can increase the time and cost of doing so. As recommended in past regulatory reviews, there is scope to streamline information required of businesses to obtain licences, potential to reduce the renewal frequency for some licences and opportunities to combine licences that groups of businesses commonly need (such as liquor and food service licences).

The Commission recommends that governments — Australian, state, territory and local — take appropriate action on previous review recommendations that remain valid and largely unimplemented. Continued failure to act on these recommendations results in ongoing unnecessary costs to businesses and the community.

In general, it appears to be comparatively quick and easy to establish a business in Australia, although requirements and experiences will vary substantially between industries and localities and also depend, for example, on whether the business is taking over existing Australian business assets or starting with site selection and asset construction. The Commission has heard of few difficulties experienced by medium and large businesses setting up in Australia and is of the view that most issues with set-up, where they arise, are related to micro and small sized businesses. The Commission welcomes feedback from businesses on this conclusion.

Government assistance programs need better focus

Government assistance for set-up, transfer and closure comes in many guises — grants, concessional loans, tax concessions, subsidised services. Many governments offer assistance to encourage business development in chosen sectors or regions and/or to support certain types of businesses that are struggling to enter or survive in the market. For example, the Queensland Government 'First Start Loans' provide up to $650 000 per applicant in assistance at below market interest rates for the establishment of primary production or fishing enterprises. The Farm Finance Concessional Loans Scheme (funded by the Australian Government and administered by the states and territories) offers concessional interest rates for farm businesses experiencing financial hardship and are intended to help improve productivity or with debt restructuring. Such programs appear to be an exercise in governments trying to pick 'winners', or to temporarily delay what is likely to be an inevitable business exit at the expense of taxpayers and other businesses that are able to operate successfully in the market.

Governments also provide assistance to attract new businesses into their jurisdictions. For example, the City of Melbourne Council offers financial assistance of up to $30 000 to small businesses currently located, or intending to locate, within the City to set up, expand or to enter into export markets. Such assistance is inappropriate, particularly if it draws resources from more economically efficient activities in more suitable locations or if those businesses would locate in the region without assistance. Resources would be better allocated, for example, to reducing barriers to all businesses in particular localities.

In other cases, government assistance has a broader underlying social objective or link to other programs that support a particular disadvantaged group in the community. For example, the Northern Territory Government's Indigenous Business Development Program provides up to $30 000 to Indigenous people to enter commercial businesses or to expand their existing businesses. The Australian Government's New Enterprise Incentive Scheme provides job seekers with accredited small business training, business mentoring, and income support to help them turn a business idea into a viable business or to become a self-employed business owner. These programs are at least partly about governments pursuing social objectives (an absence of assistance for business set-up may increase the need for other forms of assistance, such as long term welfare). Nevertheless, it is still important to regularly evaluate such programs to determine whether government assistance is required and if the existing measures are the most cost effective way of meeting the desired objectives.

Most governments offer information and advice on regulatory requirements and processes as well as on commercial matters (such as preparing business plans and accessing finance). Businesses have indicated to the Commission in past studies that industry and professional associations and other businesses are the most useful sources of information and education to them (not government directly). Therefore, these forms of government assistance should only be provided to the extent that there is a market failure and they provide an avenue that industry, professional or other private organisations do not otherwise address or provide.

There are around 44 not-for-profit operated business incubators (including business accelerators and hubs) currently operating in Australia. Many of these were established with government grants or support, and include free training, networking opportunities and access to low cost or free office space. There is also a small but increasing number of university and commercially operated business incubators, including over 100 'co-working' spaces spread across all states and territories. While most incubators are likely to ease the way of new micro business operators into their markets, the extent of any public benefits derived from business incubators remains uncertain. Given the emergence of commercially operated business incubators (as well as co-working spaces and hubs), governments should review their funding in this space to avoid displacing or duplicating private sector activity.

Assistance for entrepreneurs

There has been a stream of calls for governments to more actively promote entrepreneurialism — increasingly taken to mean start-up activity focused on potentially high value, high growth and highly innovative businesses — through business incubators, entrepreneurial education and training, tax concessions, increasing the availability of start-up capital and other measures. Calls for such support are premised on the view that entrepreneurial culture and activity enhance competition and innovation, facilitate the transfer of knowledge, including by forming an important link between research and development created in incumbent organisations (including universities) and new business models, and produce benefits — or spillovers — that are able to be captured by the wider community.

In international comparisons of entrepreneurship, Australia rates poorly compared with countries such as the United Kingdom, the United States and Canada on entrepreneurial framework conditions (finance, government policy, research and development), perceptions and motivations for entrepreneurial activity, and fear of failure.

The Commission's preliminary findings suggest that entrepreneurial skills and the confidence to start a business venture can be strengthened through entrepreneurial-focused education and training, including courses that foster adaptation to uncertain or complex environments. However, the benefits of such training dissipate over time. Furthermore, while entrepreneurial culture can contribute to the rate of business set-up, economic and demographic factors can be just as important.

Programs targeting entrepreneurialism and innovative start-ups present risks similar to those of broader business assistance programs. Focusing assistance on particular types of entrepreneurialism risks drawing limited taxpayer resources from other activities of greater value to the wider community, may not result in activity that would not otherwise have occurred, reduces incentives for entrepreneurs to compete vigorously, and induces rent seeking behaviour from other entrepreneurs pursuing similar treatment. In addition, the pace at which new high growth, innovative business models and technologies are evolving and the high risk/high reward nature of these businesses (and by definition high failure rates) makes effective program design and implementation and the achievement of broader community benefits even more difficult.

Government assistance, whether it is seeking to promote innovative entrepreneurialism, small business, or structural adjustment, is less effective in the face of broader, persistent regulatory impediments. Governments should therefore focus first and foremost on addressing existing regulatory and tax barriers to investment and competition, many of which are detailed in this report, and have been previously addressed by the Commission.

All government assistance programs for business should be subject to transparent processes that incorporate clear and credible objectives, an assessment of the economy-wide net benefits of the program, and evidence that a market would fail to deliver the desired product or service in the absence of government involvement. To enable independent evaluation of assistance programs, they should incorporate performance indicators and transparent performance monitoring.

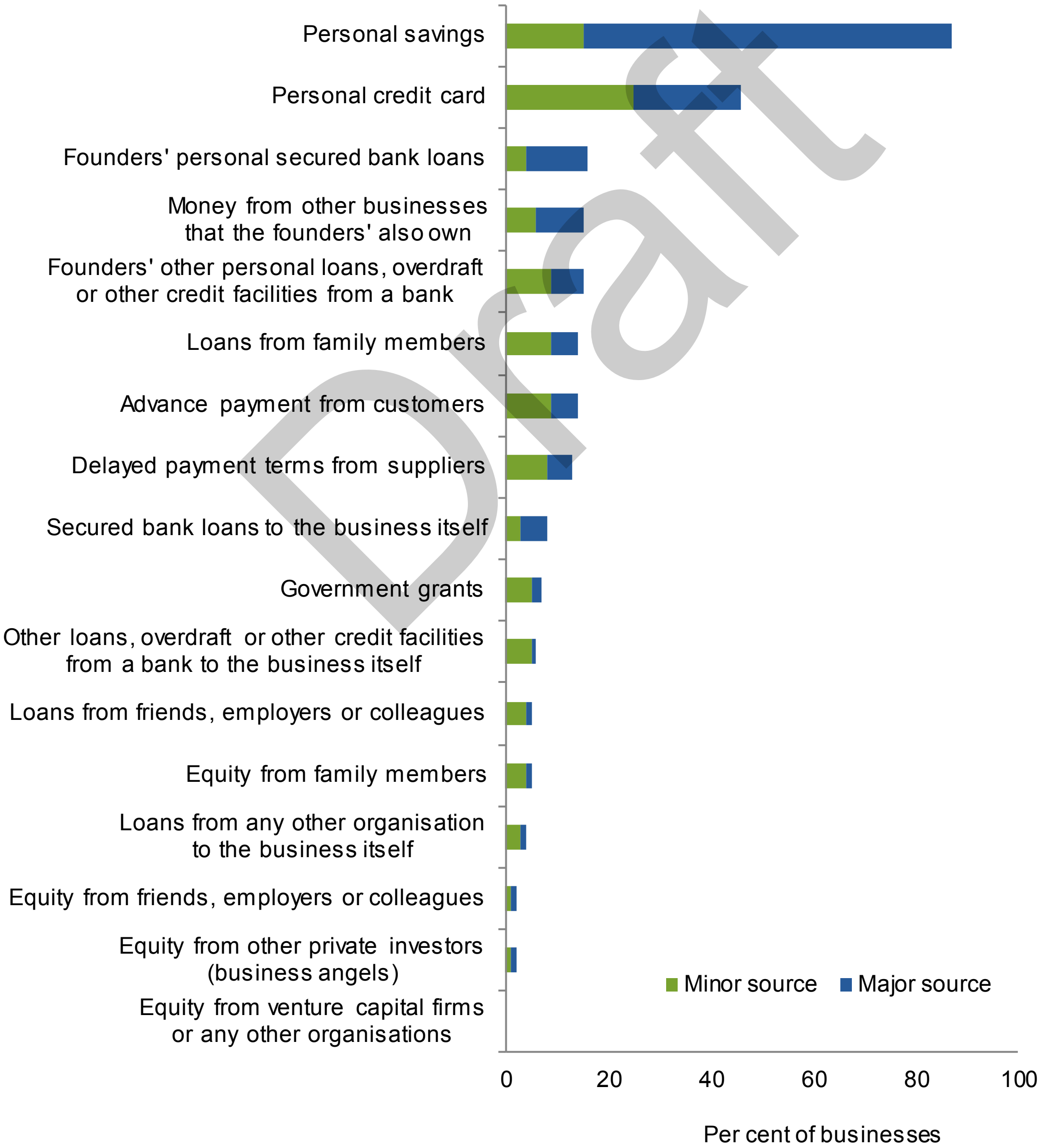
Government assistance specifically targeting entrepreneurialism should avoid micro-managing entrepreneurial activity, including through program criteria that prescribe particular business sizes, models, technologies, sectors or locations — simpler criteria based on the desired outcomes and benefits mentioned above are less likely to distort incentives and behaviours, particularly in a rapidly evolving environment. Any government support should be modest (relative to the scale of the business or market) to avoid distorting underlying markets and incentives or crowding out alternative funding or activities. Requiring matching investments from the private sector — particularly in regard to high risk/high reward ventures — can provide a useful guide of the value of government assistance. As the relevant markets are by definition dynamic, governments should embed frequent assessments to enable early learnings to be captured and for programs to evolve or end accordingly.

Access to finance is not a major barrier

Obtaining finance can be a critical early step in starting a business. The Commission's consultations have indicated that, overall, access to finance is not a major barrier to most businesses setting up in Australia, although there are a number of specific issues that need to be addressed.

Reflecting the fact that the vast majority of new businesses are micro or small, most people looking for finance for business set-up are not doing so in the name of the business, but instead are drawing on personal finance, including owner savings, personal credit cards and personally secured bank loans (often referred to as 'bootstrapping'). Funding from family and friends is also common. Of those that seek either debt or equity finance under a business name, the Commission was advised that most with a credible business plan are successful. However, for the (small) number of businesses with innovative new business models, the combination of an innovative approach/product and a lack of past credit history may make it particularly difficult to access the finance that is crucial to business growth and success.

Figure 3 **Sources of finance for nascent businesses**[a]



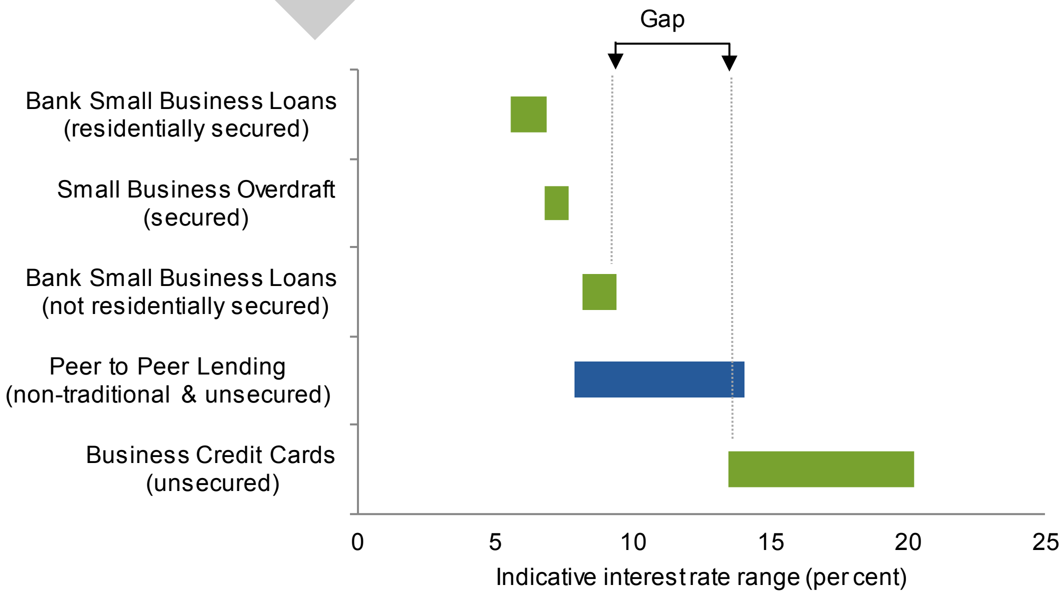
[a] A 'major source' of funding is defined as representing at least 20 per cent of total funding needs.

Debt finance is generally available, at a price

Banks are the primary source of debt finance and they usually require real estate (typically, for new micro and small businesses, the owner's home) as security against a business loan. Of those new businesses that seek debt finance in the name of the business, most generally do not experience problems (around 20 per cent of nascent or emerging businesses seek business loans). Amongst established businesses, over 90 per cent of those that sought finance in 2012-13 sought debt finance; and of these, nearly 90 per cent obtained it. The banks, governments and some professional associations provide considerable information to assist businesses with developing business plans and applying for debt finance.

However, there is a clear gap in the traditional debt financing market — for small and medium businesses with asset security, loans are typically available at around 6-7 per cent interest (compared with around 5-6 per cent on home loans); for those without asset security, credit cards with interest rates of 14-20 per cent are the usual form of financing (figure 4). There is no evidence of any systemic regulatory issues that would give rise to this gap in debt finance. Rather, it appears that banks are reluctant to be seen to offer higher interest debt finance to businesses (other than through credit cards), even to those businesses that have sufficient cash flow but little asset security. Alternatively, credit cards represent a simple and quick — albeit blunt — way to incorporate some form of higher 'risk premium' in the applicable interest rates. Typically, around three–quarters of all small business lending is secured; half to two–thirds of this lending is secured by housing. The Commission was advised that unsecured finance is more readily available in some other countries (such as the United States). The existence of a gap in the traditional financing market does *not* in itself indicate a need for government involvement.

Figure 4 **A gap in the traditional debt finance markets**



Peer-to-peer lending

Peer-to-peer lending is becoming more common in Australia and could, in time, fill the debt financing gap to some extent (current interest rates for unsecured loans, where available, start at around 8-11 per cent). For now, peer-to-peer lending remains a relatively minor source of debt finance overall and its availability is largely confined to loans for consumers and for micro and small new businesses. There are currently two tiers of regulatory arrangements for peer-to-peer lending, distinguishing between different capacities of investors. The first tier — wholesale platforms — have little regulation beyond licensing requirements and are open to institutions and 'sophisticated investors' (individuals with gross income over $250 000 for each of the last two financial years or net assets over $2.5 million). Most of Australia's peer-to-peer lenders fall in this category. The second tier — retail platforms — are open to anyone but have higher licensing requirements, monitoring from ASIC and require the production of product disclosure statements. There appear to be no significant regulatory barriers to the operation of peer-to-peer lending.

Use of equity finance is related to business size and stage of set-up

Comparatively few businesses in the set-up stage seek or use external equity finance. For some, there is no obvious suitable source of such finance. Equity financiers, even 'business angels' or venture capitalists, may not be as quick and easy for some business owners to approach as banks, are often only interested in investing in 'innovative' businesses (with substantial upside), and then only once a new concept is shown to have a viable market. For some business owners, the idea of sharing a business concept, control and potential financial returns with an additional party is considered less desirable than drawing down personal savings or obtaining debt finance. As noted above, the most significant source of external equity funding for micro and small businesses is family or friends. For medium and larger businesses, public listing and/or taking on another business as a part owner, are the primary sources of equity finance.

Public listing

Amongst medium and larger businesses, listing on a stock exchange can be an important source of equity finance. Stock exchange listing is an option only for businesses that are incorporated and tends to be undertaken by businesses seeking to expand, where government assets are privatised, or to undertake other corporate restructuring. Given the relatively fixed costs of preparing and submitting a prospectus, the costs of listing (around 6-10 per cent of funds raised) can be disproportionately high for small and medium sized businesses. A less costly and onerous 'information statement', which can be used to meet disclosure requirements for smaller equity raisings, is only used in around 10 per cent of small capital raisings.

The Commission has found no evidence of any significant barriers to stock exchange listing. On the contrary, the process is relatively straightforward, as are ongoing compliance obligations. Some stakeholders have indicated, however, that financial, legal and other advisors at times adopt a more cumbersome, risk adverse and costly approach to business prospectus preparation than is strictly necessary. This suggests there may be a need for greater clarity around listing disclosure requirements. The notion of reintroducing a secondary board on the ASX with lower governance requirements for smaller listings received no support.

Employee share schemes

Employee share schemes are particularly attractive to liquidity constrained start-up businesses as they can be used to attract and retain skilled staff without drawing on limited funds. The Australian Government has provided preferential tax and regulatory arrangements around such schemes to encourage their use by small unlisted start-up companies with limited access to capital. New arrangements come into effect from July 2015. Some stakeholders queried the rationale under the proposed arrangements for limiting the tax concessions to new businesses incorporated for less than 10 years and with annual turnover of less than $50 million.

The Commission considers that with few barriers to stock exchange listing and with other market driven forms of equity funding (such as crowd-sourced equity) for small businesses being opened up, any employee share scheme tax concessions should be confined (as proposed in the Tax and Superannuation Laws Amendment (Employee Share Schemes) Bill 2015) to small businesses with limited access to capital. The estimated cost of the tax deferral and concessions is around $200 million over 4 years. Eligibility for such concessions should include criteria on the number of employees (rather than using turnover to indicate business size) and the time since incorporation. Further, all aspects of the government's proposed employee share scheme should be subject to an independent review after it has been in operation for 5 years, to assess the effectiveness of the arrangements in meeting their objectives and the relative costs and benefits of continuing to provide preferential tax arrangements to employee share schemes.

Crowd-sourced equity

There has been a growing focus in recent years on increasing the use of crowd-sourced funding and in particular the use of crowd-sourced equity. Crowd-sourced equity funding is usually sought online and allows a potentially large number of investors to make a small investment in the business in return for an equity stake. Often when a business seeks crowd-sourced funding it is tied to the need for funds to enable the development or commercialisation of an innovative new product but no interest (equity) in the business passes to the funder (only products or services). For example, a recent Australian invented beehive with honey tap was launched on Indiegogo (a US crowd funding platform) to enable the marketing and sale of the product over the internet. The product attracted over 36 000 funders and US$12 million in its first month.

At present, there are significant regulatory barriers to the development of crowd-sourced equity funding in Australia. In particular, the *Corporations Act 2001* (Cth) limits the number of non-employee shareholders for private companies and places a prohibition on these companies making public equity offers. The Australian Government is evaluating options to reduce some of these barriers. In particular, they are considering alternative settings for the size and structure of businesses that might be enabled to use crowd-sourced equity, the amount of equity that could be raised, and disclosure and reporting obligations. The Commission considers that crowd-sourced equity funding could be opened up further, while providing some protection to small investors.

The Commission recommends the introduction of a two-tiered approach to crowd-sourced equity funding in order to balance business demands for crowd-sourced funding with protection of investor funds. Investors who are 'sophisticated' or 'professional' under the Corporations Act would be exempt from the cap on equity. Those investors who are not sophisticated or professional investors would be limited to investments of less than a capped amount. A two-tiered approach to crowd-sourced equity funding would open up equity funding for small investors in a low risk way and would bring this funding into line with Australia's peer-to-peer lending arrangements.

Venture capital

There are around 26 active venture capital fund managers operating in Australia with a total annual investment of around $200 million and highly variable returns. The Commission was advised that there is sufficient venture capital to invest in Australian businesses, a substantial number of businesses seeking such funding, but a dearth of businesses that are determined to be investible by venture capital funds.

Despite this, claims persist that more should be done by government to augment the supply of venture capital. In particular, superannuation funds have been highlighted as a potential source of funds that could be used as equity finance for new and growing businesses. Australia's superannuation reserves are reported to be amongst the largest in the world (around $1.87 trillion in September 2014). There are no regulatory barriers to the use of superannuation funds for venture capital. However, comparatively low returns on some venture capital, the relatively small investment amounts involved and the due diligence required, make direct investment in venture capital in Australia an unattractive option for superannuation funds.

The Commission considers it would be a backward step for the government to attempt to direct the investment decisions of superannuation funds and that doing so in this instance would increase the risk and potentially lower the value of superannuation for Australian retirees (based on the performance record of Australia's venture capital funds).

Voluntary business exits are usually straightforward unless planning is underdone

Nearly 95 per cent of business exits each year are for reasons other than a financial failure event, although many businesses that close are not financially strong. Businesses can be sold or closed for non-financial reasons, or passed to family members, associates or employees. For the majority of cases, it is quite simple and inexpensive to cease a business. The efficient and timely transfer of ownership or control becomes complicated with complex ownership structures, taxation issues, the transfer of leases and assets and the need for the exiting owner to have a future income stream. For example, failure to give sufficient consideration to the detail of trust deeds at the point of establishment and/or failure to anticipate how the business may evolve over time can result in considerable complexity and cost at the time of business transfer or closure.

Succession planning

Succession in ownership is an issue for non-corporate business structures but succession planning is not widely undertaken. For example, only around one third of Australian family businesses are ‘succession ready’. While always important, succession planning has become more challenging with increasingly complex business ownership structures and rapidly changing technology altering the nature of businesses to be transferred. In the case of family businesses, greater geographic dispersion of families and more variety in family structures create additional challenges.

With a decreasing proportion of business owners aged less than 35 years and an increased proportion over 65 years, there is likely to be a shortage of potential new business owners to accommodate a flood of ‘baby boomers’ exiting from their ownership in businesses over the next decade. Options for realising income from the sale of these businesses may be limited with only 40 per cent of listed businesses reported to actually sell. This may be relevant to future retirement income policy if people have invested in businesses rather than superannuation and their expectations regarding sale values are not realised.

Most governments are more interested in businesses starting and surviving rather than closing. Nevertheless, some provide information on succession planning to businesses at the time of business set-up, but even where owners take this on board, it is often outdated or irrelevant by the time the business actually closes. There is a need for business owners to self-identify their interest in business succession in order to better target such information. The Commission considers that planning for business succession is largely a commercial matter for business owners, the next generation of owners and their accountants. As such, governments should limit their own role to preparing guidelines for businesses, professional and industry associations, and accountants on regulatory arrangements relevant to exit and succession planning.

One of the most complex, time consuming and costly issues for business owners to address when a business is sold or handed over as an ongoing concern, is their tax liability. A key issue raised by small business is the complexity of small business capital gains tax (CGT) concessions. Small business concessions on capital gains tax have existed since 1985 and have been progressively expanded over time. The main reasoning behind the concession is a recognition that earnings reinvested into the business are often seen as a large part of the retirement savings of the business owners. There are currently four separate small business CGT concessions that relate to: the amount of time an asset is held for, the age of the owner relative to retirement age, whether the assets are active, and potential for deferral if asset proceeds are reinvested in another business. The Henry review and the Board of Taxation both found that CGT arrangements are overly complex for small business and there is scope for some rationalising or streamlining. There will be further consideration of CGT concessions in the White Paper on the Reform of Australia's Tax System. The Commission considers there is considerable scope to streamline the small business capital gains tax concession arrangements.

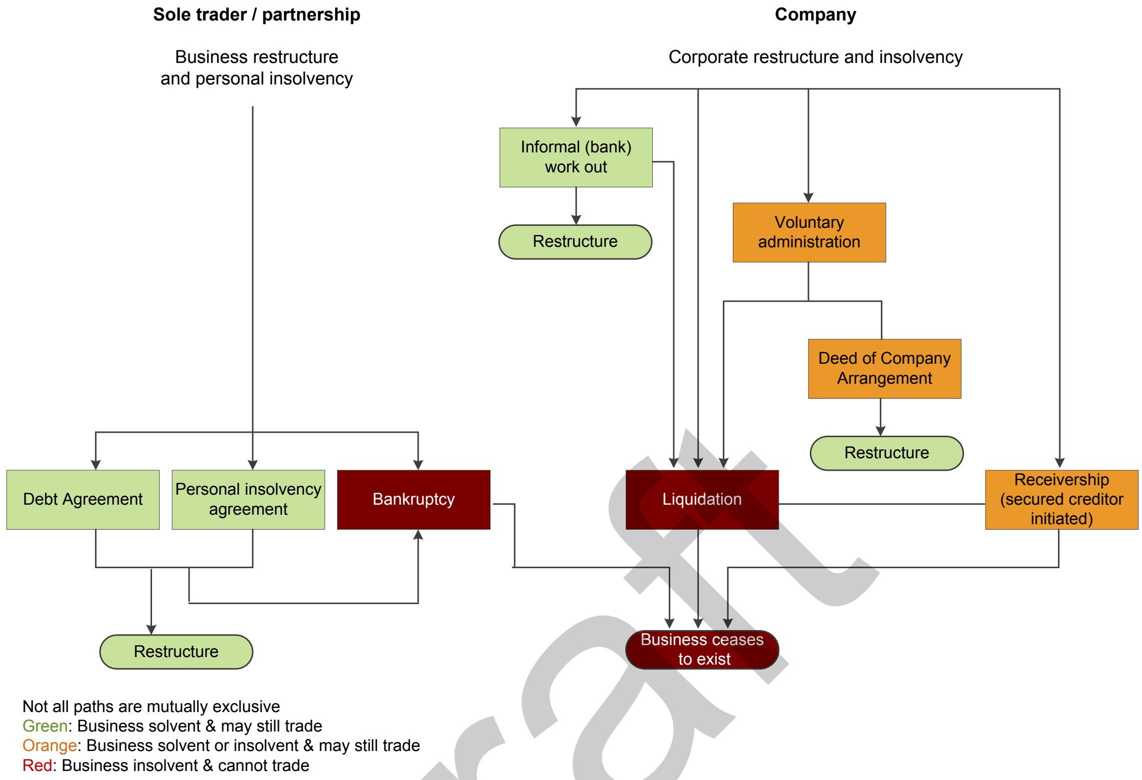
Insolvency arrangements need targeted reform

Around 6 per cent of business exits involve formal insolvency — mostly of companies but to a lesser extent other non-corporate business structures. By number, the bulk of insolvencies relate to small companies with small liabilities, but there are also some insolvencies with large sums at stake — in 2013-14, around 340 companies reported liabilities of over $10 million each when entering insolvency.

The insolvency regime facilitates the exit of a business that is unable to meet its financial obligations (figure 5). The regime sets out how claims of creditors and employees against the business are settled and may also affect the timing of closure, any restructure of the business, and the nature of restrictions on the failed business owner, including the capacity to set-up another business. The operation of the insolvency regime is critical to ensuring financially distressed businesses have an opportunity to restructure, or if that is not possible, providing an efficient, effective and orderly process for winding up. The regime should operate so as to avoid creating incentives for self-serving strategic behaviour by the business owners/directors or creditors, or a creditor race to the recovery of assets. It should also reduce the extent to which physical and environmental assets of a failing business are left to deteriorate prior to sale; result in lower transaction costs through a coordinated approach; and engender confidence in the system for the business owners, employees and creditors.

The Commission heard that, overall, the insolvency regime is operating well. However, flaws in restructuring processes, long timeframes for corporate liquidations and (at times) disproportionately onerous reporting and appeal processes suggest that some reform is necessary.

Figure 5 **Typical processes for restructuring and insolvency**



Corporate restructuring processes

Many companies attempt to avoid the publicity and stigma of formal insolvency processes by instead undergoing an informal confidential 'workout' (usually with their bank as the major secured creditor), although such an approach necessarily limits restructuring options to those centred on the secured creditor. While the confidential nature of such restructures means the extent of them is unknown, anecdotally, informal workouts have become increasingly commonplace (particularly amongst larger businesses) for those that are struggling financially.

The extent of reforms needed for Australia's restructuring processes

There is a perception that (particularly compared with US insolvency processes) Australia's insolvency regime provides insufficient focus or incentives to restructure, and instead, puts too much focus on penalising and stigmatising corporate failure. A 2014 senate committee report and the 2014 Financial System Inquiry both recommended that at least some aspects of the US approach to corporate restructuring be considered for Australia.

The Commission considers that a wholesale switch toward an insolvency regime akin to that of the United States is both unnecessary and unjustified. While the focus of the US approach to business restructure and the business retaining control of its operations seems appealing at first glance, the increased role of courts is unlikely to improve the speed or cost effectiveness of restructuring (box 1). Further, reviews of the US approach have noted that it is not suitable for the complexity of modern large companies and is too expensive for small ones. Finally, international comparisons suggest that while Australia's insolvency regime is costly, slow to get started and is less focused on restructuring, it is comparable with some other countries (including the United States) in terms of time taken, the proportion of funds recovered, creditor participation and the management of debtor assets. For example, the recovery rate in Australian insolvencies is around 82 per cent of secured debt, compared with 80 per cent in the United States and 89 per cent in the United Kingdom.

The Commission's recommended reforms to Australia's corporate insolvency regime, coupled with changes to formal restructuring arrangements, are intended to significantly improve the efficacy and success of restructuring and insolvency processes while avoiding key weaknesses of the current US approach.

Box 1 The US regime for corporate restructuring

'Chapter 11' of the US Bankruptcy Code allows the reorganisation of debt by companies (and can also be used for partnerships and individuals). A chapter 11 case commences when a company (or one of its creditors) files a petition in the Bankruptcy Court.

Unlike the use of independent voluntary administrators in Australia, a US company that enters chapter 11 becomes a 'debtor in possession' and retains control of its own affairs, albeit now owing a fiduciary duty to the creditors (whose views are represented by a committee), and operating under the supervision of the Bankruptcy Court.

The Bankruptcy Court is heavily involved in the chapter 11 process. The Court can replace the board of the debtor with a trustee in cases of misconduct, must approve any actions by the debtor outside of the normal course of business, and adjudicates challenges from creditors. Further, proposed reorganisation plans emerging from the chapter 11 process cannot proceed without the approval of the Court.

Initiating a chapter 11 process immediately freezes all creditors' rights — debts cannot be collected, security property cannot be sold and the enforcement of some ipso facto clauses in contracts are prohibited.

A chapter 11 process is typically concluded when the debtor's 'reorganisation plan' is confirmed by a vote of the creditors or alternatively, the Court approves the plan.

Voluntary administration

For struggling companies that are looking to formally restructure or continue operating rather than be liquidated, 'voluntary administration' provides a framework within which directors and creditors can investigate options. Around 9 per cent of Australian companies undergoing restructure or insolvency have a voluntary administrator appointed (who is in control of the company), compared with nearly 21 per cent in the United Kingdom. In international comparisons, the use of restructuring processes in Australia and the United Kingdom compares poorly to countries such as the United States and Canada. Almost 60 per cent of Australian companies that enter voluntary administration are deregistered within three years of the commencement of the administration. Feedback from participants indicates that the later a business begins the voluntary administration process, the fewer levers there are left to save it.

The Commission considers that earlier entry into a formal restructuring process would more effectively facilitate restructuring when there are still assets, time and scope to achieve a successful outcome. This would provide more opportunity for an orderly process to sell assets at market value in a non-distressed sale, for example.

Roles and responsibilities of company directors during restructure

To better support early restructures, consideration should also be given to the role and responsibilities of company directors during restructuring and any provisions that make it difficult for a company to continue operating once a formal restructure has commenced. In particular, the Commission recommends the introduction of 'safe harbour' provisions for company directors, such that they would be able to undertake formal restructuring activities without liability for insolvent trading. With appropriate checks on related party sales, provision should also be made for pre-positioned sales during safe harbour periods, whereby a non-distressed sale is organised in the period immediately prior to a formal insolvency appointment. Such sales could be reviewed by any subsequent external administration to ensure the assets have been sold at appropriate (market based) values, particularly if related parties are involved. Voluntary administration (and associated safe harbour provisions and pre-positioned sales) should not be an option when a business is already insolvent or when insolvency appears inevitable.

Contract continuation during restructure

Ipso facto clauses can severely constrain the ability of a business to continue trading during restructure. Ipso facto clauses allow a contract to be terminated solely due to the fact that the business has experienced an 'insolvency event' (such as the appointment of an administrator), regardless of continued payment or performance. The operation of these clauses can reduce scope for a successful restructure or prevent the sale of the business as an 'ongoing concern'. Many countries have heavily restricted the use of such clauses.

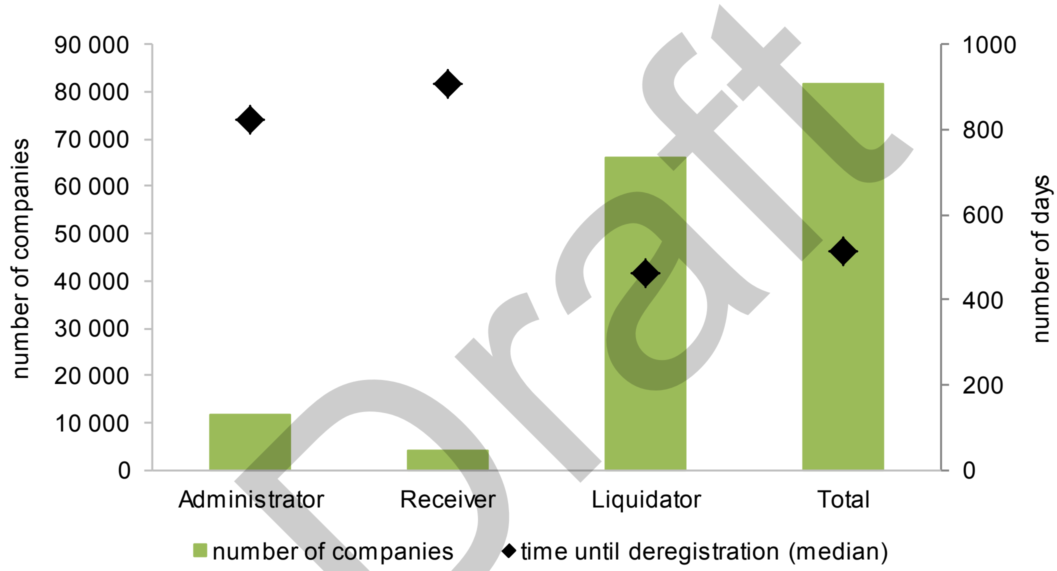
The Commission recommends that the Corporations Act be amended such that ipso facto clauses are void (unless otherwise directed by a court) when a business is controlled by an administrator (as already applies if a person is in bankruptcy). The same should apply if a company were to be utilising the safe harbour arrangements discussed above. This would not excuse the business from complying with all other terms of the contract or remove whatever termination rights the counterparty has in the event of any other breach.

Corporate insolvency processes

One of the main problems with Australia's insolvency processes is that too much time and expense goes into winding up businesses with few or no recoverable assets. Most insolvent company windups begin with the appointment of a liquidator (71 per cent) and this is also the quickest route (figure 6). The median time spent in a cessation process is around 500 days, which is comparable with or slightly above overseas cessation processes. Insolvency costs are around 8 per cent of business value in Australia, which is comparable with the United States but high relative to New Zealand and the United Kingdom.

Figure 6 **Company de-registrations**

January 2005 to December 2014 by first type of practitioner appointed



A streamlined approach for small liquidations

There is considerable scope to streamline insolvency processes for the majority of businesses through the creation of a two stream approach. Such an approach would provide one stream for small liquidations (where liabilities are less than $250 000) and another for medium and large scale liquidations that have numerous creditors involved and/or significant assets requiring redistribution. In 2013-14, around 80 per cent of reports by external administrators handling business windups related to small companies (those with fewer than 20 employees) — many of which had no assets to distribute.

For micro and small liquidations where there are no concerns about illegal activity on the part of the business owners or directors, a low cost streamlined liquidation scheme is recommended. The scheme could be implemented through the use of a liquidator drawn from an ASIC pool of approved independent liquidators. The liquidator's primary functions would be to ascertain funds available and verify no wrongdoing had led to insolvency. Other insolvency requirements, such as meetings and reports to creditors, investigations into conduct, proof of debt and advertising requirements would be reduced. This would remove delay and expense from seeking court approval on matters such as remuneration, asset sales, and degree of investigation.

A substantial part of the delay and cost in insolvency is due to the processes involved in creditors approving and challenging the insolvency practitioner's fees (which comes out of what sum, if any, can be recovered from the liquidated business). The Commission recommends that the fee structures for small liquidations be determined through a tender process into the ASIC pool. There are then several options for how this fee would be funded in the case of a liquidation with no recoverable assets, including an increase to ASIC's budget allocation. Subject to feedback from stakeholders, the Commission's preferred approach is to increment the annual review fee charged by ASIC on Australian company number renewals to include a contribution toward liquidation costs to help fund the scheme.

Role and power of parties to insolvency

Some stakeholders in recent years have queried whether the relative power afforded to creditors in Australia's insolvency regime should be reduced. Currently, a substantial secured creditor has the power to appoint a receiver or take possession of a large component of a distressed company's property/security, potentially to the detriment of restructure plans or other secured and unsecured creditors. Around 16 per cent of Australian companies entering insolvency have a receiver appointed, compared with 8 per cent of UK companies (in the last year before UK reforms removed receivership as an option).

The Commission considers that the responsibilities of receivers should be altered such that they have a duty to not cause unnecessary harm to the interests of other creditors or put at risk the preservation of the company as an ongoing concern for sale purposes.

Protecting against phoenix activity

While the Commission's reforms are intended to expedite the liquidation process, it is important that this does not facilitate further phoenix activity — that is, the shifting of a business's assets but not liabilities away from a distressed business to a newly created company that continues to trade free of tax and other debts from the distressed business. There are reported to be around 6000 businesses involved in phoenix activity, at a total cost to employees, business and government of $1.8 to $3.2 billion per year.

Phoenix activity is sometimes also associated with a siphoning of assets by business owners out of business or trust structures immediately prior to insolvency. This is an area where there is much speculation, limited data, but considerable scope to undermine the confidence of creditors in the insolvency framework, and therefore hinder the efficient closure of businesses.

While not wanting to unnecessarily increase the requirements around business set-up, strong arguments have been made in support of the introduction of simple safeguards around identification of company directors. In particular, the introduction of a director identification number, underpinned by an identification process along the lines of the 100 point identity check required to establish a bank account, would enable the monitoring of director registration (including the detection of disqualified or fraudulent directors), the collection of data regarding director appointments over time (to establish patterns of director involvement in repeat business failures) and detection of possible fraudulent and phoenix activity by the Inter-agency Phoenix Forum and investors.

Priorities in distribution of business assets

For both personal and corporate liquidations, the underlying principle governing distribution of business assets is one of equality — all persons similarly situated are entitled to equal treatment in the distribution process. The exception to this is if a receiver is appointed by a secured creditor. In that instance, the secured creditor tends to have priority over other company stakeholders. In most insolvencies, those administering the business windup have first claim on business assets.

Employees of the insolvent business also have comparatively high priority in the distribution of assets, sitting above unsecured creditors such as the ATO. However, because there are often insufficient funds available on liquidation and to ensure more equitable treatment for employees of failed small and medium businesses, the Australian Government funds an employee entitlement scheme — the 'Fair Entitlement Guarantee' scheme. Prior to this scheme and its predecessors (dating back to 2000), the Government assisted with employee benefits for failed businesses but this tended to be on an ad hoc basis and focused on prominent failures.

In 2013-14, around 11 000 employees from 1100 businesses (11 per cent of businesses entering liquidation) received benefits under this scheme. While the numbers of businesses and employees receiving benefits have fluctuated with general liquidation activity since the scheme's introduction, average payouts have increased substantially in recent years. The government is currently legislating to address the area of the largest increase in payments (redundancy pay) through a 16 week cap on Fair Entitlement Guarantee redundancy payments. The Commission supports a continuation of the Fair Entitlement Guarantee and considers it likely that the legislated changes to redundancy payments, combined with the scope for sanctions on company directors under the Corporations Act, should reduce any moral hazard issues. Nevertheless, the success of these measures, and any evidence of moral hazard, should be reviewed within five years of implementation.

Personal insolvency

In Australia, personal insolvency (bankruptcy) is dealt with separately to corporate insolvency and is largely invoked as an avenue for winding up insolvent self-funded micro and small businesses (although most bankruptcies in Australia relate to personal rather than business-induced financial distress). Bankruptcy arrangements were reformed in 2010 and are part of the current Insolvency Law Reform Bill 2014 (Cth).

The Commission has, at this stage, identified only one issue with bankruptcy arrangements that is of relevance to this inquiry — the ‘exclusion period’ and associated restrictions on bankrupts (the bankrupt individual cannot act as a company director, and is restricted in terms of access to finance, employment opportunities and overseas travel). In Australia, the exclusion period is 3 years with potential extension up to 8 years; in the United Kingdom, the period was reduced in 2004 to a default of 12 months (subject to action from the Official Receiver). The Commission considers that the exclusion period should be reduced from 3 years to 1 year, with the trustee and Courts retaining the power to extend the period (to a maximum of 8 years). This should help reduce the stigma attached to bankruptcy, and encourage entrepreneurs to start new businesses, while still preserving regulatory oversight to prevent abuse of the bankruptcy process.

Draft findings and recommendations

Regulatory arrangements around business set-up

DRAFT RECOMMENDATION 3.1

Governments, particularly those at a state, territory or local level, should fully and promptly implement the leading practices and recommendations from the Commission's previous reports on business regulation, including:

- *Performance Benchmarking of Australian Business Regulation: Cost of Business Registrations* (2008)
- *Performance Benchmarking of Australian and New Zealand Business Regulation: Food Safety* (2009)
- *Performance Benchmarking of Australian Business Regulation: Occupational Health and Safety* (2010)
- *Performance Benchmarking of Australian Business Regulation: Planning, Zoning and Development Assessments* (2011)
- *Performance Benchmarking of Australian Business Regulation: Role of Local Government as a Regulator* (2012)
- *Regulator Engagement with Small Business* (2013)

DRAFT RECOMMENDATION 4.1

In principle, there should be a consistent approach to the taxation of business entities regardless of their ownership structure and size. The White Paper on the Reform of Australia's Tax System should consider in particular:

- the taxation of trusts used primarily for business purposes
- the tax treatment of profits and losses and the feasibility of a simpler entity for small business that would combine features of existing structures.

DRAFT RECOMMENDATION 10.1

Governments should implement the Harper Review's recommendations with respect to removing or reviewing industry-specific anti-competitive regulations. In reviewing their regulations, governments should assess whether they generate a net benefit to the wider community or whether they are the best way of achieving government objectives.

DRAFT RECOMMENDATION 10.2

Governments should maintain the pace of reform to their land tenure arrangements, particularly focusing on those that may inhibit the establishment of new businesses. Consideration should be given to the scope and duration of leases on land, flexibility of land titles, native title determination processes and the accessibility of land tenure information.

Regulation of new and innovative business models

DRAFT RECOMMENDATION 8.1

All jurisdictions should provide a framework for fixed term exemptions to specific regulatory requirements that deter entry by business models that do not fit within the existing regulatory framework.

Regulators should have the capacity to place conditions on the exemption to protect consumers, public health and safety, and environmental outcomes. Such exemptions should be disallowable instruments and subject to public review prior to expiry.

More generally, governments should:

- continually review industry-specific regulatory approaches to assess whether they remain relevant and provide a net benefit to the community and are the most effective and efficient means by which objectives can be achieved, and
- ensure that regulation and regulators are flexible and adaptive in the face of evolving technologies and business models and properly funded for this task.

INFORMATION REQUEST

The Commission seeks participants' views on other regulatory tools available and their merits, such as 'no action' letters, that would provide some regulator discretion around the operation of new business models.

INFORMATION REQUEST

Are there valid circumstances for compensating incumbent businesses affected by regulatory changes that accommodate new business models? If so, what are they?

DRAFT RECOMMENDATION 9.1

The graduated regulation framework for payment systems should be clarified and enhanced along the lines proposed in the 2014 Financial System Inquiry. The enhanced framework should be published to provide clarity to new stored value systems and should reflect the degree of risk posed to consumers and the financial system of sufficiently small payment system participants.

In particular, the Australian Securities and Investments Commission (ASIC) and the Australian Prudential Regulation Authority (APRA) administered regulation should only apply to 'large and widely used' payment system providers. In consultation, ASIC, APRA and the Reserve Bank of Australia should determine appropriate thresholds. APRA should also develop a two-tiered regulation framework for purchased payment facilities (PPFs) where PPFs can choose between operating under 100 per cent liquidity ratio requirements or other strengthened prudential requirements.

DRAFT RECOMMENDATION 9.2

The Payments System Board of the Reserve Bank of Australia should designate the Cabcharge payment system and set an access regime for Cabcharge non-cash payment instruments. The applicability of relevant aspects of the MasterCard and Visa access regimes for the Cabcharge payment system should be considered.

DRAFT RECOMMENDATION 9.3

The Australian Transaction Reports and Analysis Centre should regulate digital currency businesses for anti-money laundering and counter-terrorism financing purposes, given the high growth potential of digital currencies and the likely low costs of including them within the regulatory framework.

DRAFT RECOMMENDATION 9.4

Crypto-currencies, such as Bitcoin, should be treated as a financial supply for GST purposes. This would require that the definition of money be updated to include crypto-currency in both the *A New Tax System (Goods and Services Tax) Act 1999* (Division 195) and relevant GST Regulations.

INFORMATION REQUEST

Would the powers of the Payments System Board of the Reserve Bank of Australia relating to access and competition in payment systems be more appropriately placed with the Australian Competition and Consumer Commission?

Government assistance

DRAFT RECOMMENDATION 11.2

All government assistance programs for business should be of fixed duration, subject to transparent assessment of the economy-wide net benefits, and incorporate clear and credible objectives, performance indicators and independent evaluation.

Any promotion of entrepreneurialism by governments should:

- target desired outcomes and community benefits, such as knowledge or network spillovers and technology transfers resulting from innovations (rather than prescribing specific business models, sectors or locations)
- be modest, relative to the scale of the business or market
- require matching private sector funds or support where possible, and
- embed frequent assessments to enable early learnings and necessary program evolution or program end.

DRAFT RECOMMENDATION 11.1

All governments should give priority attention to:

- providing information and assistance on commercial matters, and through mentoring, skills and training, only where a market failure in private provision is clearly demonstrated
- reviewing assistance to business incubators
- removing assistance that is intended to attract new businesses to their jurisdiction
- reviewing structural adjustment assistance.

Access to finance

DRAFT FINDING 5.1

Access to finance does not represent a barrier for most new businesses. Only a minority of new businesses seek finances beyond the financial resources of the owners, and most that do seek external finance obtain it.

DRAFT FINDING 7.2

While some new businesses are unable to obtain debt financing, there is no evidence to suggest that there are regulatory impediments restricting the ability of new businesses to access debt in Australia that require a policy response.

That some businesses rely on credit cards as a significant source of debt finance can be viewed as evidence of a funding gap. However, the existence of a gap in the traditional financing market does *not* in itself indicate a need for government involvement and new lending models, such as peer-to-peer lending, represent innovations that could go some way to filling the gap.

INFORMATION REQUEST

Are current regulations around peer-to-peer lending efficient and effective? Are there any barriers – regulatory or otherwise – that restrict the operation and growth of peer-to-peer lending in Australia?

DRAFT FINDING 7.1

Credit Guarantee Schemes are not an efficient way to improve access to debt finance for new businesses.

DRAFT RECOMMENDATION 7.1

As identified in the 2014 Financial System Inquiry, the Australian Government should undertake a review of the participation of the lending industry in comprehensive credit reporting in 2017 with a view to determining whether participation should be mandated. The review should also consider extension of reporting to include the comprehensive credit history of businesses.

DRAFT RECOMMENDATION 7.2

Unless clear and persistent economy-wide net social and economic benefits can be demonstrated, governments should cease to offer concessional loans to individuals seeking to start a business. Government programs for concessional loans to new businesses on the basis of their location or their industry should be ended.

DRAFT RECOMMENDATION 6.1

The Australian Government should introduce a two-tiered regulatory structure for crowd-sourced equity funding. The first tier would be directed at those investors determined under the *Corporations Act 2001* (Cth) to be ‘sophisticated’ or ‘professional’ and would not restrict possible investment. The second tier would be directed at other less experienced investors and would include a cap on individual investments.

INFORMATION REQUEST

What impediments (apart from those specific to the Corporations Act 2001 (Cth) for crowd-sourced equity funding) are there to the use of crowd-sourced funding in Australia? What protections should be afforded to investors, consumers and businesses that use crowd-sourced funding platforms?

DRAFT RECOMMENDATION 6.2

If the Australian Government intends to provide assistance to small start-up companies with limited access to capital via additional tax concessions under an employee share ownership scheme, eligibility should be based on:

- the number of employees in the company
- the length of time the company has been incorporated
- the company being unlisted
- the application of the employer eligibility criteria to related companies
- the employing company being an Australian resident taxpayer

If the Tax and Superannuation Laws Amendment (Employee Share Schemes) Bill 2015 is passed, all aspects of the taxation and effectiveness of employee share schemes should be reviewed five years after commencement of the legislation.

The Australian Government should make legislative changes to remove the cessation of employment as a deferred taxing point for equity or rights granted by an employer.

DRAFT RECOMMENDATION 6.3

The Australian Government should not require superannuation fund trustees to allocate funds to particular asset classes or investments, including venture capital or small businesses.

Voluntary business exits

DRAFT RECOMMENDATION 12.1

In line with recommendations from the Harper Review, the Australian Competition and Consumer Commission should implement more streamlined formal merger exemption processes that remove unnecessary restrictions and requirements and improve the efficiency and effectiveness of business transfer processes.

DRAFT RECOMMENDATION 12.2

The current small business capital gains tax concessions should be rationalised. The White Paper on the Reform of Australia's Tax System should consider the recommendations of the Henry Tax Review relating to small business capital gains tax relief with a view to the effectiveness of implementation, avoidance of unintended consequences and ensuring consistency with broader tax policy.

DRAFT RECOMMENDATION 12.3

Planning for business exit is largely a commercial matter for business owners, the buyers or next generation of owners and their advisors. Governments should provide general guidelines for business and business advisors on exit requirements and provide information on commercial matters only when a market failure in private provision is clearly demonstrated and Government provision would be effective.

Business restructuring

DRAFT FINDING 14.2

The current culture, incentives and legal framework around voluntary administration inhibit its effectiveness as a genuine restructuring mechanism.

DRAFT FINDING 14.1

While some specific reforms are warranted, wholesale change to the Australian insolvency system is not justified.

In particular, several factors — including the costs of the process, the role of courts and changes to the roles of creditors and debtors — indicate that the overall costs are disproportionate to any likely gains from a wholesale adoption of chapter 11 of the United States Bankruptcy Code.

INFORMATION REQUEST

Is there available data relating to the frequency and importance (in terms of the overall value of debt) of informal workouts? If not, how should the Commission obtain this information — for example by a survey of banks or insolvency practitioners?

DRAFT RECOMMENDATION 15.1

Section 436A of the *Corporations Act 2001* (Cth) should be amended such that a company may only appoint an administrator (and commence an 'independent restructuring' process) when the directors form the opinion that the company may become insolvent at some future time, but is not currently insolvent.

- The option to appoint an administrator to restructure when the company is insolvent should be removed.
- If an administrator determines the company is insolvent, liquidation should be commenced.

DRAFT RECOMMENDATION 15.2

The *Corporations Act 2001* (Cth) should be amended to include provision for a 'safe harbour' to allow companies and their directors to explore restructuring options without liability for insolvent trading. During such a period, the directors would retain control of the company, but receive independent advice from registered advisers.

- Advisers appointed in safe harbour would be disqualified to act as administrators, receivers or liquidators in any subsequent insolvency process for the company.

- The company would be required to inform the Australian Securities and Investments Commission, and the ASX in the case of listed companies, of the appointment of an adviser.
- In informing themselves and the adviser, and determining whether to act on any restructuring advice, directors would be under a duty to exercise their business judgment in the best interests of the company's creditors as a whole, as well as the company's members.
- If the positive thresholds above are met (and evidenced), a director's duty not to trade while insolvent would be considered to be satisfied during the period of advice and for actions directly related to implementing the restructuring advice.

DRAFT RECOMMENDATION 15.3

Provision should be made in the *Corporations Act 2001* (Cth) for safe harbour periods to result in 'pre-positioned' sales (where a non-distressed sale is organised in the period immediately prior to a formal insolvency appointment).

- External administrators in subsequent insolvency processes should have the ability to review the sales, and where there are no related parties, overturn them only if they can prove that the sale was not for reasonable market value.
- If there are related parties, there is no presumption favouring sale and the administrator's examination of the sale process continues as normal. The administrator's review should include checks that the sale has met existing regulatory requirements for related party transactions.

INFORMATION REQUEST

The Commission seeks participants views on further aspects of the design of a 'safe harbour' for directors, particularly:

- *When should safe harbour be available, and not available, especially in relation to the changes to voluntary administration suggested in draft recommendation 15.2?*
- *What protections should be included to ensure that safe harbour is not abused by directors seeking to avoid liability? For example, would time limits on the advice and/or any subsequent actions limit abuse of the process or simply hinder the process itself?*
- *Should companies (or individual directors) only be able to access safe harbour a limited number of times in a given time period — for example once every 3 years?*
- *What interaction should there be between safe harbour processes and any other subsequent insolvency process should restructuring fail or not be pursued? Particularly, should insolvent trading be simpler to prove where safe harbour requirements have not been properly followed?*

DRAFT RECOMMENDATION 15.4

The *Corporations Act 2001* (Cth) should be amended such that *ipso facto* clauses that allow termination of contracts solely due to an insolvency event are unenforceable if a business comes under the control of an administrator or receiver (as already applies if a person is in bankruptcy) or if the company is utilising the safe harbour arrangements set out in draft recommendation 15.2.

In circumstances where this moratorium could lead to undue hardship, suppliers should be able to apply to the Court for an order to terminate the contract.

INFORMATION REQUEST

The Commission seeks participants' views on any protections that would be required to ensure contractual 'work arounds' do not undermine the intent of draft recommendation 15.4.

In particular, is there international evidence of regulatory systems where the enforcement of ipso facto clauses has been successfully suspended during an external administration? Are there examples of work arounds that have undermined this? In these cases, have the work arounds been significantly detrimental to any later formal restructuring process?

INFORMATION REQUEST

Should a moratorium on creditor enforcement actions during schemes of arrangement be introduced?

What effects would this have in light of some of the Commission's other proposed reforms. Specifically, would it have a substantial additional impact on the effectiveness of schemes over and above a moratorium on ipso facto clauses? Would removal or streamlining of court involvement affect the benefits available?

INFORMATION REQUEST

Is there scope for additional use of alternative dispute resolution and other non-judicial options within the insolvency process? Is this possible under current law, would it require legislative change or would constitutional issues affect its design? In particular:

- *Would an 'insolvency panel', operated as a form of expert witness, reduce costs in insolvency process, particularly when considered alongside the Commission's other reform proposals? How could this be implemented?*
- *Should any panel be able to hear matters across all insolvency issues, or would some subset, such as schemes of arrangement, be more appropriate?*
- *How many court hearings would such a panel displace? Would this represent a wholesale replacement of the court, or simply an addition (in time and cost) to existing processes?*

Corporate insolvency

DRAFT RECOMMENDATION 15.5

The *Corporations Act 2001* (Cth) should be amended to provide for a simplified 'small liquidation' process.

- This would only be available for those companies with liabilities of less than $250 000, creditors would be able to opt out of the process and into a standard creditors' voluntary liquidation, and the Australian Securities and Investments Commission (ASIC) would be able to initiate further investigation if it has concerns of illegality.
- The primary role of the liquidator would be to ascertain the funds available, to a reasonable extent given a reduced timeframe.

- In line with this, there would be no requirement for meetings of or reports to creditors, nor investigations into officers' conduct or other illegalities (unless ordered, and recompensed, by ASIC).
- Liquidators for these processes would be drawn from a pool of providers selected by tender to ASIC. The tenders would be subject to review every five years.

INFORMATION REQUEST

The Commission seeks participants' views on matters relating to the implementation of draft recommendation 15.5:

- *What should the threshold be for a company to be subject to a small liquidation?*
- *To what extent can the proof of debt and advertising requirements be reduced for small liquidation?*
- *How would the small liquidation process interact with reforms under the Insolvency Law Reform Bill 2014 (Cth)? Will these interactions require further changes to the Bill?*
- *Should changes be made to directors' duties in line with the proposed small liquidation threshold?*

DRAFT RECOMMENDATION 15.6

The *Corporations Act 2001* (Cth) should be amended to alter the powers and duties of receivers:

- The duties to obtain best prices under section 420A should be subject to a duty not to cause unnecessary harm to the interests of creditors as a whole, including putting the continuation of the company, or the preservation of the company as an ongoing concern for sale purposes, at risk.
- The existing powers of a receiver should remain. However, any proposed courses of action, particularly involving sale of assets, that are outside the normal course of the debtor's business, would be subject to a simple majority vote of all creditors. This vote would be waived if, in the receiver's opinion, there would be no funds to distribute to unsecured creditors after secured creditors are paid.
- Secured creditors would retain the right to appoint receivers as dictated by the conditions of the security. Such appointments may not be overturned by simple votes of creditors, but may be overturned if the court determines that the receiver is not acting in accordance with the duties above.
- These changes would only apply to security contracts entered into after the date of assent of the amending legislation.

INFORMATION REQUEST

What effect would the Commission's proposed reforms, specifically in draft recommendation 15.6 have on the cost of capital? Is this supported by evidence from similar reforms in other jurisdictions?

INFORMATION REQUEST

Is there any evidence that receivers have acted in a manner prejudicial to the interests of other creditors, or unduly threatened the continued existence of the business?

What evidence is there that the behaviour of secured creditors has changed over time? Has the use of receivers and liquidators reduced in preference to informal workouts?

DRAFT RECOMMENDATION 15.7

The Fair Entitlements Guarantee scheme should continue, with specific provisions subject to the passage of the Fair Entitlements Guarantee Amendment Bill 2014 (Cth) to alter the cap on redundancy payments in order to address the primary realisation of moral hazard issues.

The *Corporations Act 2001* (Cth) should be amended to allow the Commonwealth to play a more active role as a creditor. In line with this, the Active Creditor Pilot should become a permanent part of the scheme.

The operation of the Fair Entitlements Guarantee, in its entirety, should be reviewed in 2021 in order to monitor any moral hazard issues, potential abuse of the scheme and continued effectiveness of recovery arrangements.

DRAFT RECOMMENDATION 15.8

Section 117 of the *Corporations Act 2001* (Cth) should be amended to require that, at the time of company registration, that directors must also provide a Director Identity Number (DIN).

A DIN should be obtained from the Australian Securities and Investments Commission (ASIC) via an online form at the time of an individual's first directorship. In order to obtain a DIN individuals should be required to provide 100 points of identity proof, and verify that they have read brief materials on directors' legal responsibilities provided as part of the online registration.

For existing companies, their directors should be required to obtain a DIN. The director DINs should then be provided to ASIC at the annual review date for the company, as a change to company details. To enforce these requirements, ASIC should be empowered under section 205E of the *Corporations Act 2001* (Cth) to ask a person who is a director to provide their DIN.

INFORMATION REQUEST

Given the sophisticated grouping used to undertake phoenix activity, would there be merit in allowing courts to pierce the 'corporate veil' to require that parent (or related) companies pay the debt of insolvent subsidiaries? How complicated would this be to enforce?

What would the relative costs and benefits be of adopting a system similar to that used in New Zealand and Ireland?

INFORMATION REQUEST

The Commission seeks participants' views on changes to the Australian Securities and Investments Commission's (ASIC's) funding, powers and approach that could assist the efficiency of the insolvency process. In particular:

- *In order to facilitate investigation where warranted in 'small' liquidations, should additional funding be provided to the Assetless Administration Fund? What are the relative costs and benefits of using a levy on the annual review fee for Australian Company Number renewals to provide this funding?*
- *Are changes needed to the criteria for accessing the Assetless Administration Fund?*
- *In addition to reforms under the Insolvency Law Reform Bill 2014 (Cth), are there other means to improve ASIC's data collection and utilisation?*

INFORMATION REQUEST

Should the process for the insolvency of trusts (and managed investment schemes) be aligned with the approach under the Corporations Act 2001 (Cth)? If so, how should this be implemented?

Are there any unique features of trusts that would prevent the broad adoption of such an insolvency process?

Would this lead to any unintended consequences (such as distortions in choice of business structure) or would it instead address current distortions?

Personal insolvency

DRAFT RECOMMENDATION 13.1

Section 149 of the *Bankruptcy Act 1966* (Cth) should be amended so that, where no offence has occurred, individuals are automatically discharged from bankruptcy one year following the filing of a statement of affairs.

The trustee, and the courts, should retain the power to extend the bankruptcy period to up to eight years if there are concerns regarding the debtor's conduct or ability.

The Australian Government should work with other governments and professional bodies to ensure that any regulations or other arrangements restricting the employment of bankrupts beyond the period of bankruptcy are justified according to specific and efficient policy objectives.

INFORMATION REQUEST

Are there circumstances where it would be appropriate for a bankrupt to continue as a company director? If so, what framework would be required? How could the interests of creditors (of the individual and any affected company) be appropriately protected while still allowing the bankrupt to work as a director?

INFORMATION REQUEST

What means are currently available to investigators, regulators and courts to prevent, detect and undo asset siphoning? Are these sufficient? Are other means necessary, and if so, what reforms are needed? Are these matters best dealt with in terms of personal insolvency, or in broader contexts such as tax reform?

1 Scope of the inquiry

1.1 Inquiry background

To strengthen Australia's international competiveness, the Australian Government in 2014 announced its Industry Innovation and Competitiveness Agenda. One of the four pillars of the Agenda is to develop an industry policy that fosters innovation and entrepreneurship. The Agenda noted that entrepreneurship and business start-ups promoted employment creation and productivity growth. These types of businesses benefited the broader economy by testing new ideas, developing new products and implementing new business models (Australian Government 2014c).

In announcing this inquiry, the Minister for Small Business, noted the importance of freeing up entrepreneurial activity to enable ideas to be turned into new business ventures (Hockey and Billson 2014). In addition, the Minister for Small Business has highlighted that Australian business, particularly small business, may be falling short of its innovative and entrepreneurial potential due to policy barriers that increase risk (Featherstone 2014).

There is also a view that in comparison to other countries, Australia lacks the necessary start-up ecosystem to foster new and innovative businesses and that Australia's insolvency arrangements could be improved to facilitate business closure and the redeployment of assets and encourage more entrepreneurial activity.

1.2 What this inquiry is about

This inquiry is about the impediments faced by those setting-up, transferring or closing businesses in Australia. The establishment, transfer and closure of businesses are natural features of a dynamic and productive market economy and can have significant positive impacts.

New businesses can offer new products or services, adopt a new process or operating model, put competitive pressures on existing businesses and may provide spill-over benefits to other parts of the economy. Other businesses are established primarily to provide employment and income for the business owner and their immediate families. Business establishment decisions can be influenced by lifestyle considerations, such as a desire for work flexibility, to obtain some income from a pastime or hobby, or to live in a particular location. The set-up of not–for–profit businesses can be motivated by a desire to provide services for a particular community or group, generate funds for a charitable cause or provide employment for people suffering from disadvantage or disability.

The closure of existing businesses can have significant negative consequences for those directly involved, but can also free up labour, capital and other inputs for more productive uses. As is the case at business set-up, personal decisions weigh heavily on business closure as people may close a business to retire or return to employment elsewhere.

The Commission has been asked to undertake a broad ranging investigation into the barriers to business set-up and closure and how overall economic efficiency could be improved by removing or reducing these barriers. In particular, the Commission has been asked to investigate, analyse and develop recommendations on:

- the nature and extent of barriers to entry and exit that exist for firms and the impact of these barriers on overall economic performance
- appropriate options for reducing these entry and exit barriers, including advice on aspects such as: the regulation of product and service markets; regulatory and licensing requirements affecting the ease of starting, operationalising or closing a business; transfers and subsidies to businesses including import barriers; and the impacts of the personal and corporate insolvency regimes on business exits.

While the interests of business will be a key consideration in developing recommendations to remove or reduce barriers, in keeping with its legislation, the Commission will seek to ensure that its proposed recommendations provide the best outcomes for the wider community.

In preparing its draft report, the Commission has conducted its own analysis and drawn heavily on input from participants through consultations, written submissions and stakeholder comments provided via the inquiry website. The Commission's consultation processes with stakeholders are detailed in appendix A.

Which businesses are in scope of this inquiry?

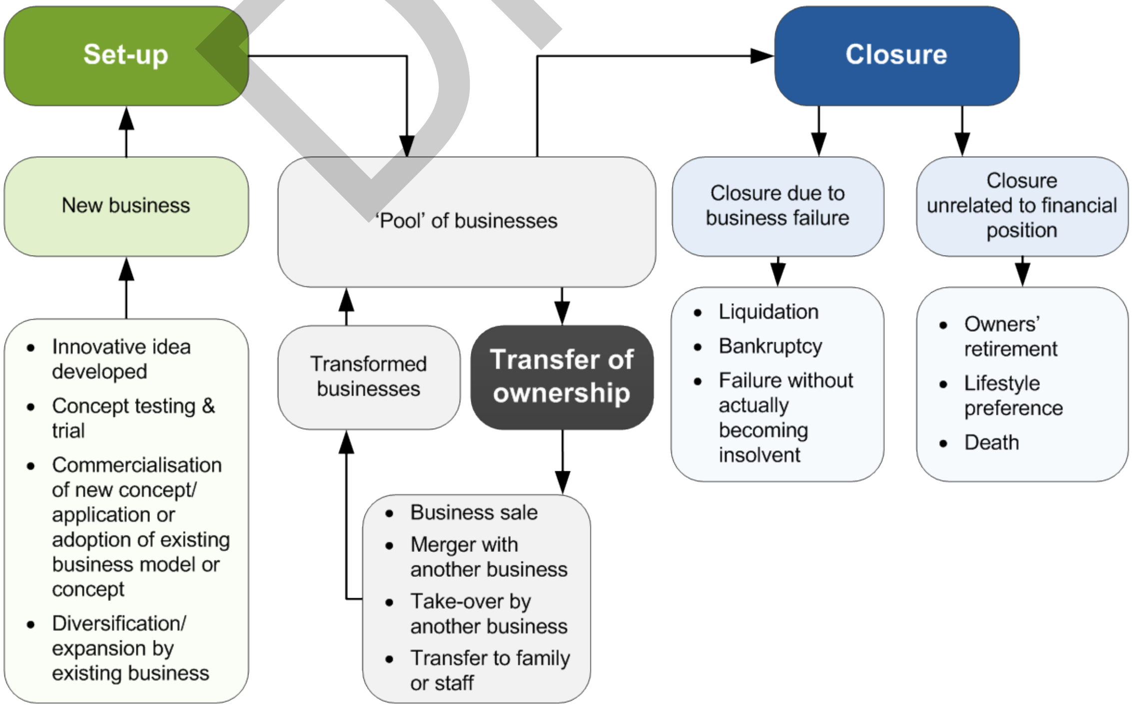
For the purposes of this inquiry, a business is considered to be an entity (profit or not-for-profit) that actively trades goods and services. Not-for-profit businesses are in scope to the extent they compete with other businesses and face similar regulatory and other barriers to set-up, transfer and close their business. The inquiry will cover businesses established under all ownership structures including sole traders, partnerships, trusts and companies. While most businesses start off small, the inquiry is not limited to small businesses — rather, barriers to entry and exit faced by small, medium and/or large businesses will be investigated.

What is meant by set-up, transfer and closure?

Business set-up, transfer and closure determine the stock or 'pool' of businesses in the Australian economy (figure 1.1). Rather than being a defined point in the life of the business, set-up, transfer and closure are stages (of a duration that varies with the business's circumstances and specifics) that a business progresses through. The specifics of each of these stages, for the purpose of this inquiry, are discussed below.

- *Set-up* — the business is established as an entity. Prior to actively trading, a business usually undergoes a development and product testing phase where it is known as a 'nascent' business. Factors affecting the process of business set-up can include, the rationale for setting up as a business, business structure, industry specific and land-use regulation, access to finance, digital business models, access to payments systems and government regulations and assistance.
- *Transfer* — the change in business ownership. There are various degrees of change in ownership — a business may be completely sold, taken over, merged with another business or transferred to family members or associates. A transferred firm is considered an exit from the stock of businesses, often undergoing a transformation in structure and operations before re-entering.
- *Closure* — the business ceases to actively trade. The majority of closures are unrelated to the financial position of the firm, but rather reflect the personal circumstances of the owners such as retirement or lifestyle preferences. Where closure is related to financial failure, exit can be because of the inability of the business to generate a sufficient return or due to the insolvency of the business where it is unable to meet its financial obligations. Insolvency takes two forms, corporate insolvency and personal bankruptcy.

Figure 1.1 **Business set-up, transfer and closure**



The Commission does not intend to examine the impact on ongoing business operations of regulatory requirements and processes such as licence renewal, compliance with regulation, inspection and enforcement regimes. Nor will it examine ongoing interactions of operating businesses with the taxation and workplace relations systems. However, those aspects of these regulatory and policy areas that impact on the decisions of business owners to either set-up, transfer or close their business will be considered.

1.3 Other reviews and work of relevance

There is a large body of work relevant to this inquiry that has been undertaken in recent years, including reviews, inquiries and studies on: the regulatory costs placed on business in general and specific industries; the performance of businesses in certain sectors and the operation of specific regulatory regimes, such as planning, zoning and development assessment; the impact of subsidies and assistance as well as the personal and corporate insolvency regimes. The relevant aspects of existing work in these areas are detailed in chapter 3.

A number of these reviews, inquiries and studies have drawn attention to the barriers imposed on business as a result of local government regulation. The Commission acknowledges that local government regulation, such as the requirement to obtain the relevant licencing and approvals, can have a significant impact on business set-up and closure. For this inquiry, the Commission intends to draw on previous work in this area undertaken both by the Commission and others where relevant, rather than undertake new analysis.

The Commission has had regard to the recently released Financial System Inquiry (The Treasury 2014d) and its analysis and recommendations to facilitate future innovation in the financial system, particularly the recommendations that aim to:

- remove unnecessary regulatory impediments to innovation, particularly for small business fundraising and in the payments system
- facilitate the identification of innovation opportunities
- strengthen Australia's digital identity framework
- develop data driven business models by improving access to public and private sector data.

The Commission is also aware that the Competition Policy Review, which was released in March 2015, covers some areas of relevance to this inquiry. The final report noted that technological change has facilitated innovation and new business models and that existing laws and institutions can struggle to keep pace (Harper et al. 2015). Finally, the development of a White Paper on the Reform of Australia's Tax system is an appropriate mechanism to fully address a number of tax-related issues that are identified in this draft report.

Other reviews that may be relevant include the current Senate Standing Committee on Economics inquiries into Digital Currency (due to report in August 2015) and Australia's Innovation System (due to report in July 2015). There is also the statutory review of the *Anti-Money Laundering and Counter-Terrorism Financing Act 2006* (Cth) being conducted by the Attorney-General's Department that is scheduled to conclude in 2015.

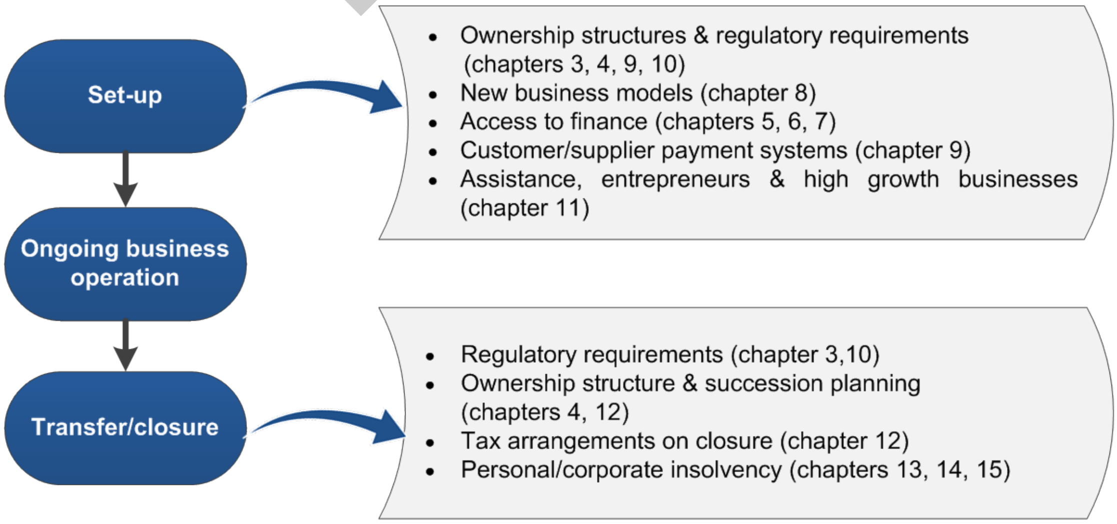
The Commission is also aware of the draft bill, the Insolvency Law Reform Bill 2014 (Cth) and its proposals to remove unnecessary costs in the insolvency process, promote competition in the market, increase confidence in the insolvency profession and improve transparency between stakeholders.

1.4 Guide to the report

A guide to where this report deals with the specific issues relating to business set-ups, transfers and closures is outlined in figure 1.2. Broadly, the importance of business set-ups, transfers and closures and key drivers of these are discussed in chapter 2. Chapters 8 and 9 consider innovative new business models and developments in business payments systems. Chapters 3 to 7 and chapters 10 and 11 examine a wide range of regulatory, institutional and financial factors that influence primarily set-ups, but ultimately can also impact on the manner and ease with which businesses close. The closure of businesses — through transfer, personal insolvency (bankruptcy) or corporate insolvency — is examined in chapters 12 to 15.

The appendixes cover the inquiry processes (appendix A) and provide further detailed data (appendixes B and C) to support the chapters.

Figure 1.2 **Guide to where specific issues are dealt with in the report**



2 Understanding business set‑ups, transfers and closures

Key points

- Just over 2.6 million businesses were actively trading in Australia at the end of 2013-14. Around 98 per cent of these businesses were small and almost 70 per cent had no employees.
- In recent years, there has been a downwards trend in entries and exits as a proportion of all businesses. Around 13.5 per cent of all businesses were new and around 12.5 per cent ceased operations. The majority of closures are unrelated to financial failure, reflecting the owners' lifestyle preference or the closure of the business without insolvency.
  - A similar trend is evident in many OECD countries and despite it, Australia still had a relatively high set-up rate and a moderate rate of closure.
- Small businesses account for over 99 per cent of all set-ups and closures. Between 2010-11 and 2013-14, entry and exit rates for small businesses were around three times higher than that for medium and large businesses. The likelihood that a business survives increases with entity size and new businesses have lower chances of survival than already established businesses.
- It is a major decision to set-up, transfer or close a business. In addition to personal considerations, the decision is influenced by: macroeconomic conditions; community and industry attitudes to entrepreneurial activity; competition and market structure; and government regulations and policies.
- The ease that a business can be set-up, transferred and closed contributes to productivity growth, higher incomes and improvements in community wellbeing.
- The rate of business set-up reflects the ability of individuals and businesses to innovate and try new processes or products. Set-ups can benefit the economy:
  - by introducing new goods and services that increase consumer choice, improve the operation of existing markets and create new markets,
  - by increasing the productivity and range of uses for labour and other resources in the economy and by providing employment to business operators and their families.
- Although closures impose costs on those individuals and businesses directly and indirectly involved, they can provide a number of economy-wide benefits:
  - transfers and closures facilitate the allocation of resources.
  - business set-ups and subsequent closures enable entrepreneurs to gain experience and experiment over time — entrepreneurs learn how to do business better next time and gain information about demand and risk in particular industries or geographic areas.
- Set-ups and closures enable the process of creative destruction. Successive waves of innovation through set-up and closure allows for the establishment of completely new industries and markets, which are of higher value to society than those that were replaced.

2.1 Recent trends in business set-up, transfer and closure

The stock of businesses in the Australian economy is like a 'pool'. Every year, thousands of businesses close and flow out, while new businesses are established and flow in. New entrants can result from new set-ups as well as from transformed businesses re-entering the economy following a change in ownership.

The set-up, transfer and closure of businesses are natural features of a dynamic, efficient and productive market economy. How readily this process is carried out will influence the overall efficiency of the Australian economy, economic growth and community wellbeing (as discussed in section 2.4).

Although the 'pool' of businesses is an easy concept to understand, its size varies according to how a business is defined (box 2.1). For the purposes of this inquiry, a business is considered to be an entity (for-profit or not-for-profit) which actively trades goods and services.

Box 2.1 **Measuring the number of businesses in Australia**

The number of businesses in the economy depends on how a business is defined. In the broadest sense, businesses can be counted as all entities that are required to be registered or on a narrower focus, just those businesses that are actively trading goods and services.

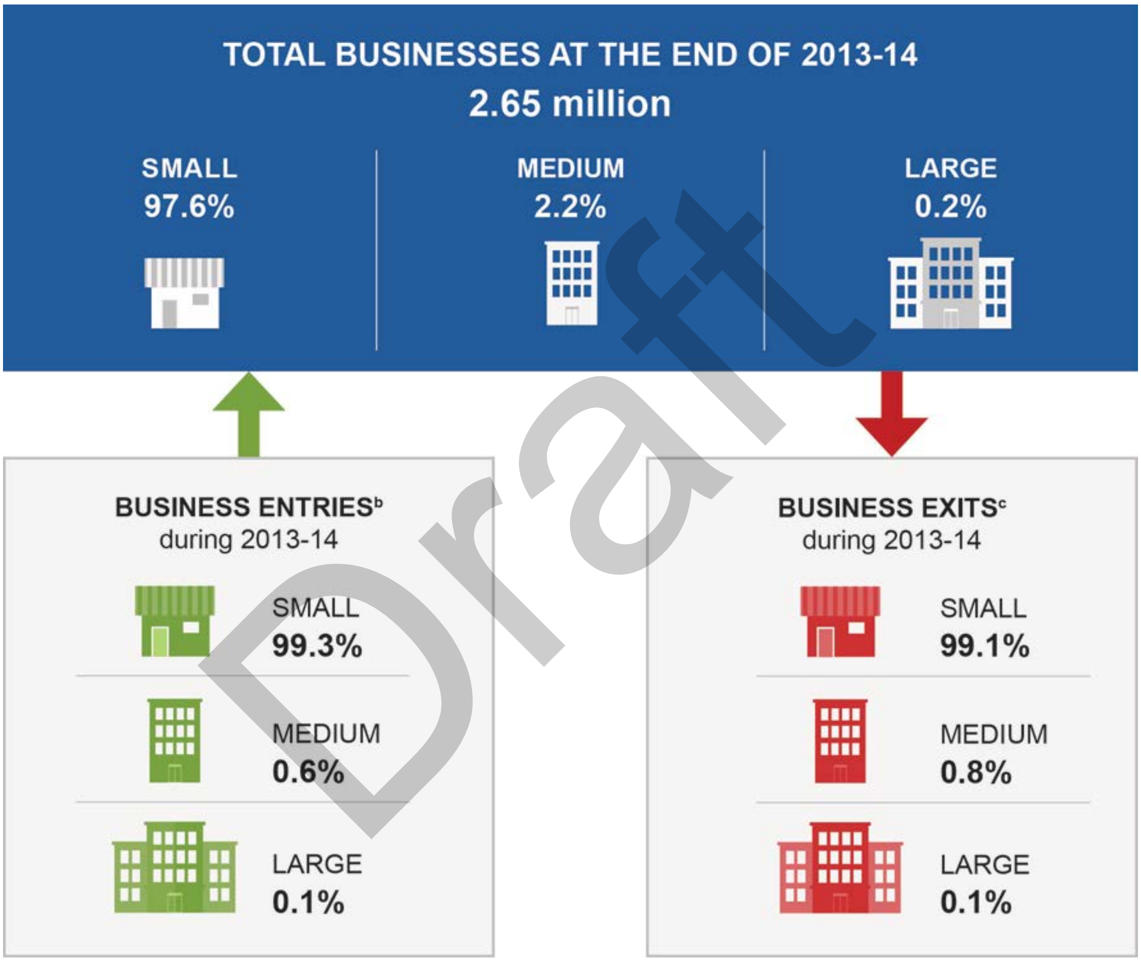
The Australian Business Register (ABR) counts entities that primarily undertake legal and financial transactions, such as superannuation funds, cash management trusts and property strata. Inactive businesses can also remain on the ABR for an extended period of time. In 2014, around one quarter of survey respondents indicated that they were no longer using their business registration (ABR 2014b). Reported inactivity was even higher for sole traders and partnerships (41 and 35 per cent respectively). Based on the scope used in this inquiry, the ABR overstates the number of businesses.

In contrast, the Australian Bureau of Statistics (ABS) understates the number of businesses, by only counting for-profit businesses registered for the Goods and Services Tax (GST). Businesses operating in the non-market sector, such as charities and sporting clubs, are also excluded. Many not-for-profit businesses have to meet the same regulatory requirements and standards and operate in the same market as commercial businesses. To consumers, not-for-profit businesses provide goods and services in largely the same manner as commercial businesses.

Constructing an extended time series of entries and exits using ABS data is limited by scope changes. Appendix B outlines these methodological differences in greater detail.

Just over 2.6 million businesses were actively trading in Australia at the end of 2013-14 — around 2.1 million were GST registered, 0.5 million were other businesses not GST registered and another 0.05 million were operating on a not-for-profit basis. The majority of these businesses were small with fewer than 20 employees and around 67 per cent of all businesses had no employees (figure 2.1). Small businesses represented around 40 per cent of (non-financial sector)[1] employment in 2012-13 (down from other recent years). While medium and large businesses are a small share of the total business population, they accounted for over 50 per cent of employment and around 65 per cent of output (ABS 2014b).

Figure 2.1 **Businesses in Australia[a]**
2013-14



[a] Active businesses are defined by the ABS to be those registered for GST that have reported in one of the last five quarters (or one of the last three years for annual remitters). In addition to the ABS measure, the number of businesses at the end of 2013-14 includes not-for-profit institutions and other non-GST registered businesses that actively trades goods and services. A small business is defined to have fewer than 20 employees, a medium business has 20-199 employees and a large business has more than 200 employees. Business size percentages for entries and exits exclude not-for-profit institutions and other non-GST registered businesses. [b] Entries refer only to ABS measure and include business set-ups, reactivations and businesses that have recommenced trading. [c] Exits refer only to the ABS measure and include closures and businesses that have stopped trading.

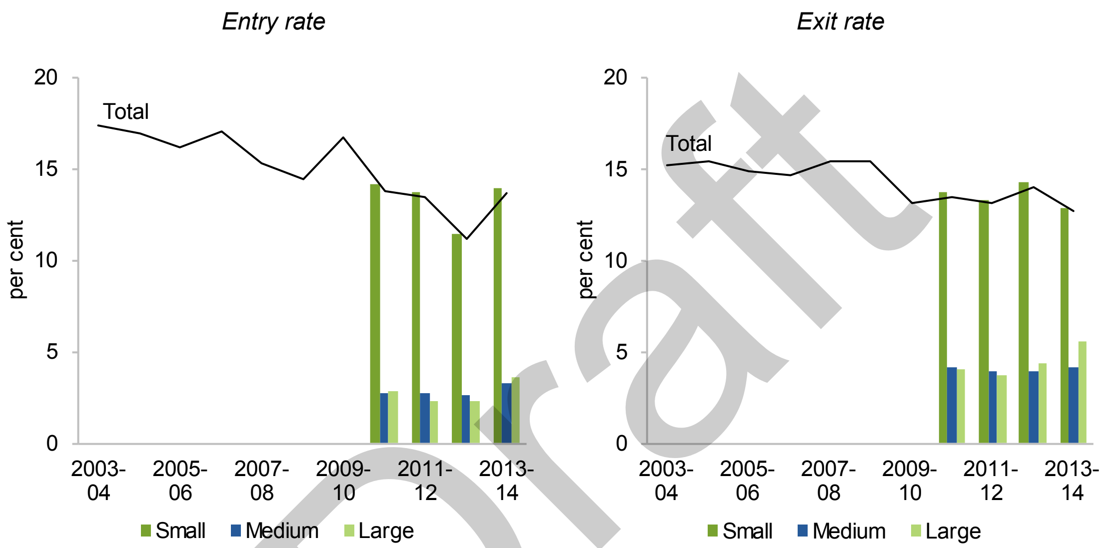
Source: Commission estimates based on ABS (2015c) and ATO statistics

1 The ABS only publishes employment and output shares by business size for the non-financial sector.

Thousands of businesses enter and exit the economy every year. In 2013-14, the number of businesses in the economy increased, as around 12.5 per cent of all entities exited and another 13.5 per cent entered. A minority of exits reflect financial failure — insolvency accounted for around 6 per cent of all exits in 2013-14 and a small group fail financially without becoming insolvent (AFSA 2014c; ASIC 2014e).

Despite the number of businesses increasing in 2013-14, there has been a general decline in entries and exits as a proportion of all businesses over the last decade (figure 2.2).

Figure 2.2 **Business entry and exit rates[a], by business size[b]**



[a] Entry and exit rates are calculated as a percentage of businesses in each category at the beginning of the financial year. This time series draws on a number of ABS publications, each of which have different methodologies. The GST threshold was increased in 2007-08, this effectively raised the turnover requirement for a business to be considered actively trading and may have influenced the rate of entry and exit. [b] Entry and exit rates by business size are available on a consistent basis from 2010-11. A small business has fewer than 20 employees, a medium business has 20–200 employees, and a large business has more than 200 employees.

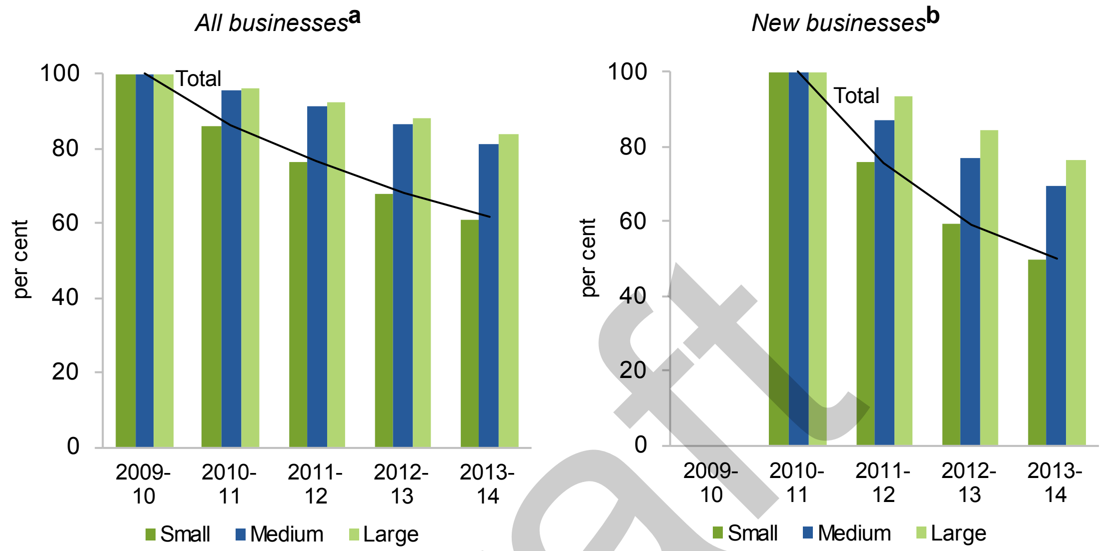
Source: ABS (2007, 2012, 2015c)

Small businesses make up the majority of entries and exits

Small businesses account for over 99 per cent of all entries and exits. The rate of entry and exit generally declines with business size. Between 2010-11 and 2013-14, entry and exit rates for small businesses were around three times higher than that for medium and large businesses. The smallest businesses, those with no employees, had the highest entry and exit rates.

The likelihood that a business survives increases with entity size. Around 60 per cent of small businesses operating in 2009-10 were still operating at the end of 2013-14, in comparison, to around 80 per cent of medium and large businesses. New businesses have even lower rates of survival. Only 50 per cent of businesses set-up or recommencing trade in 2010-11 were still actively trading three years later (figure 2.3).

Figure 2.3 **Business survival rates, by business size**



[a] All businesses that were operating at the end of 2009-10. [b] All businesses that were set-up or recommenced trading in 2010-11.

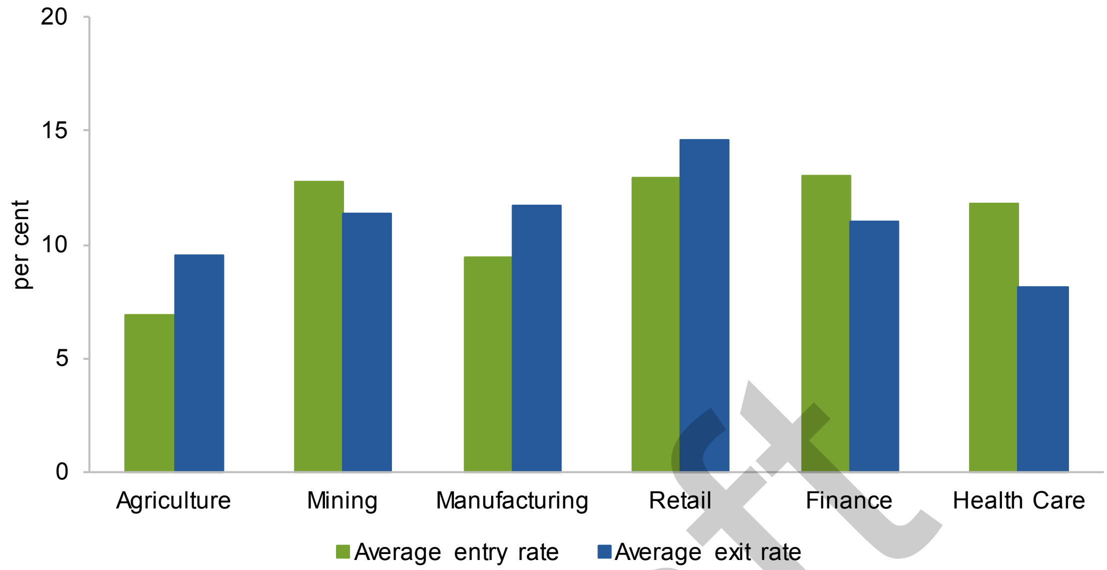
Source: ABS (2015c)

Entries and exits vary by business structure and industry

Entries and exits also vary by the type of business structure — companies and trusts are becoming the preferred structure at set-up, while sole traders have the highest rate of closure. The advantages and issues associated with establishing under alternative structures are discussed in chapter 4.

Reflecting the diversity of the Australian economy, business entry and exit rates vary between industries. Between 2010-11 and 2013-14, the number of businesses grew most strongly in the services sector of the economy, particularly in health care and finance (as entries exceeded exits). The largest declines were in the primary and secondary industries of agriculture and manufacturing, while business numbers increased in the mining industry (figure 2.4). Appendix B outlines business entry and exit rates in greater detail.

Figure 2.4 **Business entry and exit rates, selected industries**[a]
2010-11 to 2013-14



[a] Average of entry and exit rates between 2010-11 to 2013-14.
Source: ABS (2015c)

Few businesses are innovative and have high growth potential

As noted in chapter 1, businesses are set-up for a range of reasons — including to provide employment for the owner and their family or to satisfy a lifestyle choice. Because of these differences in purpose and the owners' aspirations, the level of innovation within a new business can be characterised as either:

- *Replicative* — these new businesses operate in the same manner as other businesses already actively trading. Generally, replicative businesses operate with few employees. In recent years, over 60 per cent of all businesses and an even greater share of newly set-up businesses had no employees, while a little under half of all business owners were operating as independent contractors (ABS 2013b, 2015c).
- *Innovative* — these businesses change the current operations of existing markets or establish completely new markets by introducing new products, processes, marketing methods or organisational approaches. Although it is difficult to determine the degree of innovation within a business, evidence suggests that very few businesses are innovative in Australia. The Commission estimates that around 1.6 per cent of all businesses (new and existing) introduced a product that was 'new' to the world in

2012-13, a similar share introduced a product that was 'new' to Australia.[2] The introduction of innovative operational processes or marketing methods was even less common, estimated to be in the range of 0.2-0.7 per cent of all businesses. A similarly small proportion of new businesses are likely to be innovative. Estimates suggest there were around 1000 knowledge based 'high tech' set-ups in 2013 — around 0.1 per cent of all businesses or 0.4 per cent of business entrants (StartupAUS 2014).

While innovative firms account for a small proportion of all businesses, these high growth potential businesses generally have a greater influence on the broader economy. For example, businesses established to develop an innovative product or introduce a new digital platform are likely to have greater turnover and employment generation prospects than those set-up with lifestyle factors in mind. Across all OECD countries, high growth businesses typically account for around 2-4 per cent of all businesses and despite this, have contributed substantially to net job creation through strong rates of growth (Clayton et al. 2013; OECD 2013a).

While the evidence for Australia is limited, high growth potential businesses appear to make a significant contribution to economic growth and employment creation. These businesses are more likely to be product based and operate in so called 'high tech' industries. High growth potential businesses have a greater propensity to seek external finance, are more successful in receiving finance and have higher prospects of survival than regular replicative businesses (Gordon and Davidsson 2013).

The owners of high growth potential businesses in Australia generally have broader experience and higher education levels than the owners of regular businesses. They are more likely to have previous industry and international work experience, be concurrently working on a number of entrepreneurial projects and hold an advanced university degree. High growth potential business owners are also more likely to work as a team through a joint venture rather than as an individual (Gordon and Davidsson 2013).

Who owns and operates Australia's businesses

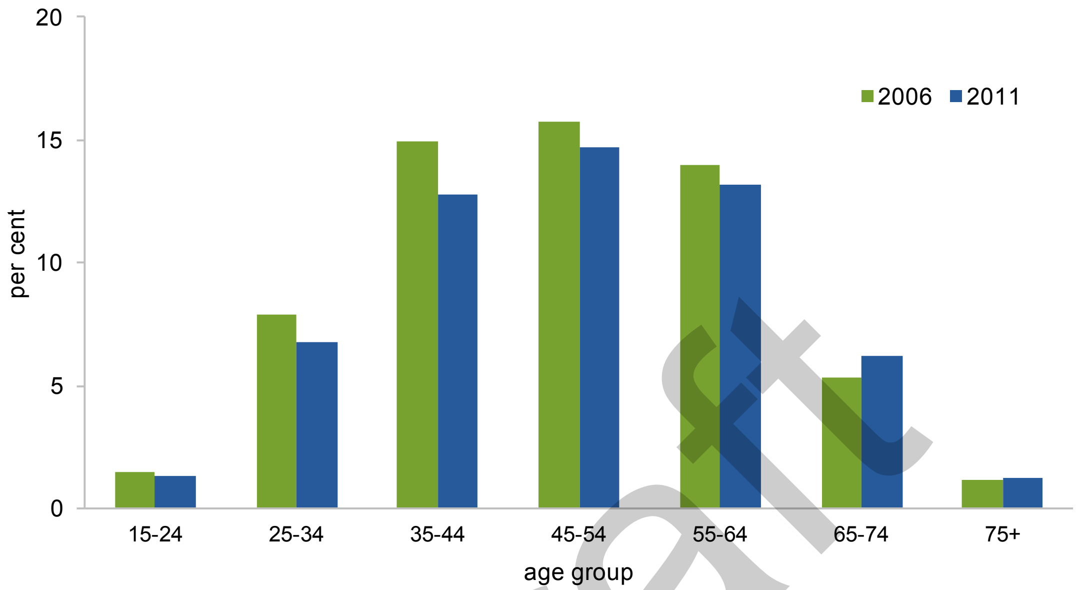
Around 2 million Australians owned and operated a business at the end of 2012. While only accounting for a small proportion of all employed persons (17 per cent), business owners also generate additional employment opportunities. In 2013-14, nearly 40 per cent of all businesses had at least one employee (ABS 2015c).

The prevalence of business ownership varies with age. In 2011, levels of business ownership were highest for those aged between 45 to 54 years (15 per cent of the age group). Owning a business at a younger age is relatively uncommon and between 2006 and

2 Rates of innovation are based on ABS (2014e) innovation estimates for employing firms, non-employing businesses are assumed to innovate at the rate observed by Soames et al. (2011, p. 45) for sole traders. Proportions are relative to the Commission's estimate of the number of actively trading businesses.

2011 became less common. In contrast, levels of business ownership have increased for those aged over 65 (figure 2.5).

Figure 2.5 **Business ownership rates, by age[a]**



[a] Business ownership as a proportion of the population in each age group.

Source: ABS (2013a)

Business owners tend to be older than the broader workforce

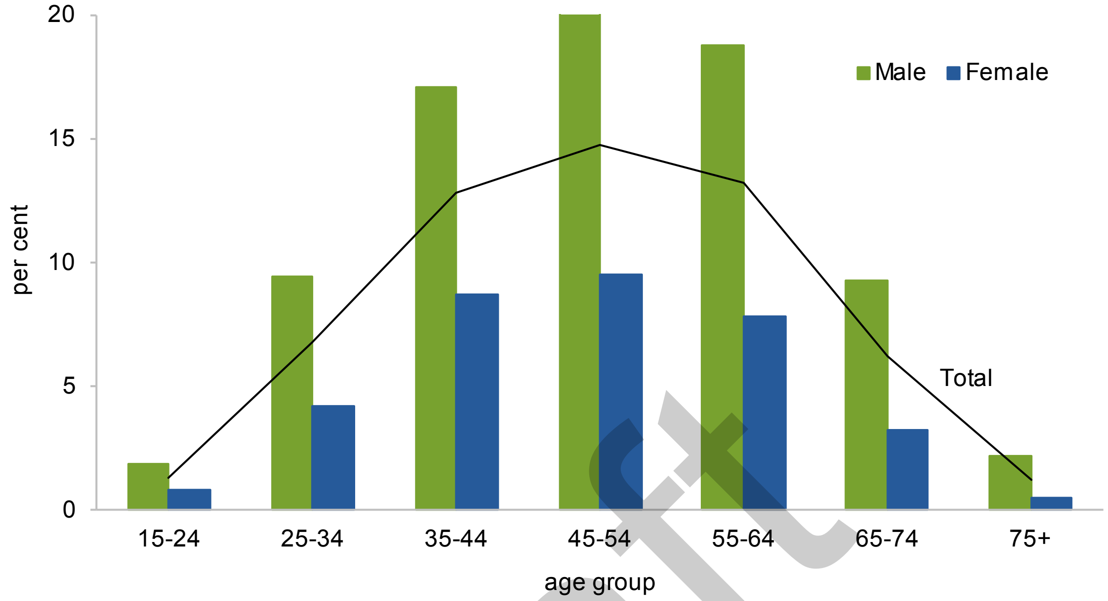
The average age of Australian business owners has increased, (by one year between 2006 and 2011) to 47 years, in comparison to the broader workforce where the average age of 40 years has remained unchanged over the same period. Nearly one in ten business owners are now beyond the traditional retirement age of 65 and another one in five are within 10 years of the retirement age. While business ownership may be another way to generate a retirement income (realised on sale of the business or its assets), these trends may present issues for the transfer of business ownership (this is discussed further in chapter 12).

Business owners are likely to be male

A higher proportion of men than women tend to run their own business. In 2011, business ownership was the main form of employment for around 12 per cent of males compared with 5 per cent of females. These differences are consistent across all age groups; nearly 20 per cent of males aged 45-54 owned a business in 2011, twice the rate of female business ownership (figure 2.6). On average, male business owners were more likely to have been in business for over 20 years (24 per cent) compared with females (15 per cent) (ABS 2013b).

Figure 2.6 **Male and female business ownership rates, by age**[a]

2011



[a] Business ownership as a proportion of the population in each age group.

Source: ABS (2013a)

While females have lower rates of business ownership, the number of females owning their own business has steadily increased over the last decade (BankWest 2013). Similar ownership trends are evident for 'high tech' set-ups, as the proportion of female founders increased to 19 per cent in 2013 (up from 16 per cent in 2011) (StartupMuster 2014). Reflecting lifestyle preferences and employment patterns in the general workforce, a majority of female business owners work part time possibly to undertake caring roles.

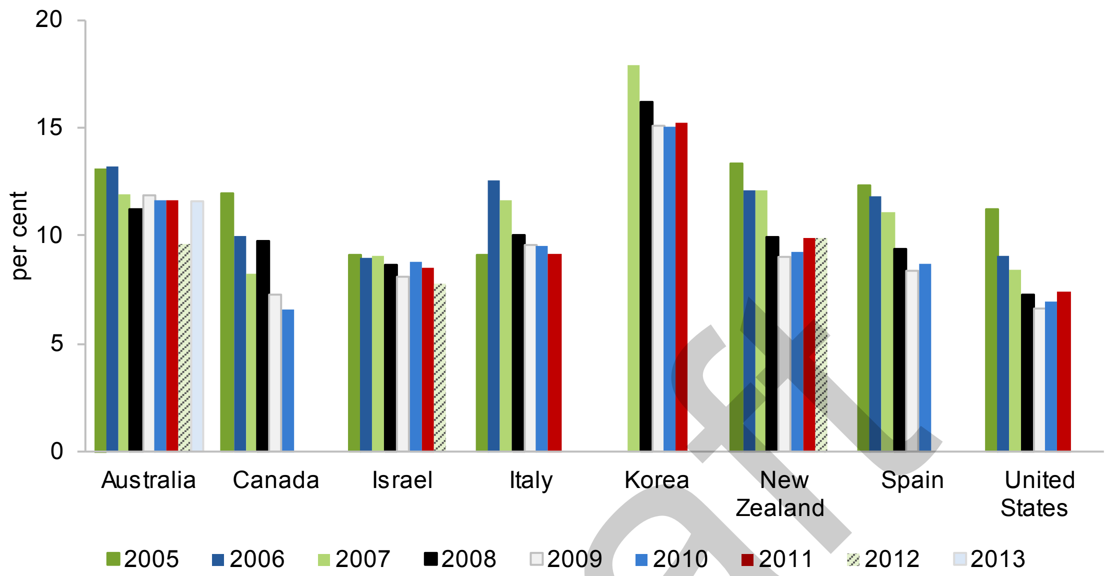
Australian business owners come from all cultural backgrounds, work in a range of industries and have varied education levels. Further background on who owns a business is presented in appendix B.

How does Australia compare?

While cross-country comparisons can be limited by definitional and methodological differences (Bartelsman, Haltiwanger and Scarpetta 2009), they do provide some indication of how readily businesses are set-up, transferred and closed in Australia compared with other countries.

Australia has a higher rate of set-up for employing businesses than most other comparable OECD countries. South Korea has had the highest entry rates, while Israel, Canada and the United States have had lower rates than Australia between 2005 and 2013. The general decline in business formation over this period in Australia appears to be relatively modest compared with evidence in some other countries (figure 2.7).

Figure 2.7 **Entry rate for employing businesses, selected OECD countries[a]**

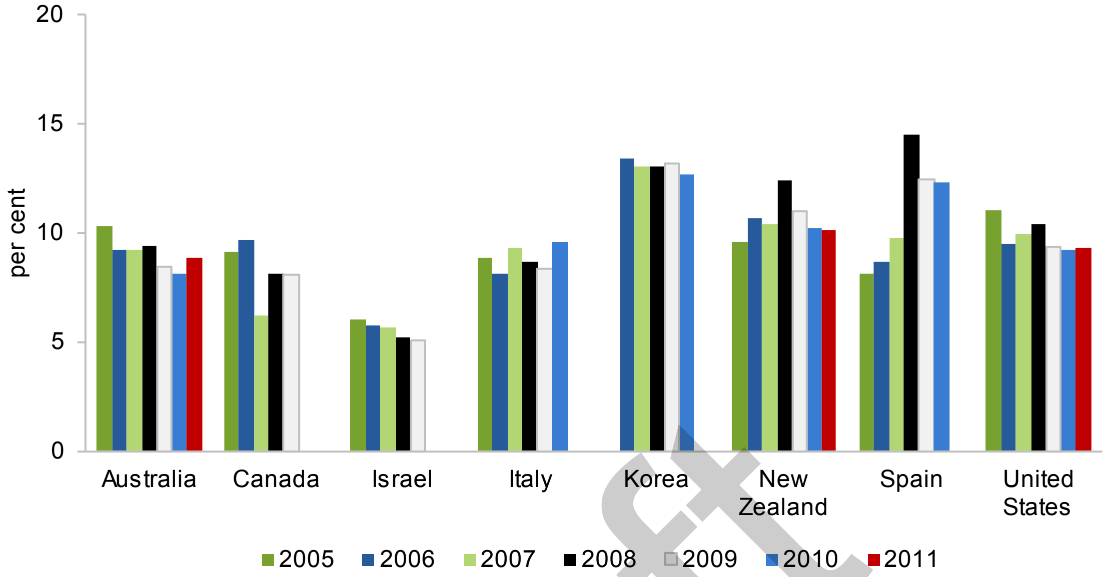


[a] The entry rate for employing businesses refers to the birth of a business with at least one employee as a proportion of all active businesses with at least one employee. It does not include mergers, split-offs or restructuring of a set of businesses. International comparisons based on employing businesses have been found to be more relevant than indicators using all businesses because results are sensitive to the coverage of business registers.

Source: ABS (2007, 2014d); OECD (2013a, 2014a)

Australian employing businesses have similar rates of closure compared with other OECD countries. Those countries with high entry rates, such as South Korea, also had high exit rates between 2005 and 2011. The lower rates of closure in Israel and Canada were mirrored by lower entry rates. While the Australian exit rate declined marginally during this period, exit rates increased in some other countries (figure 2.8).

Figure 2.8 **Exit rate for employing businesses, selected OECD countries[a]**

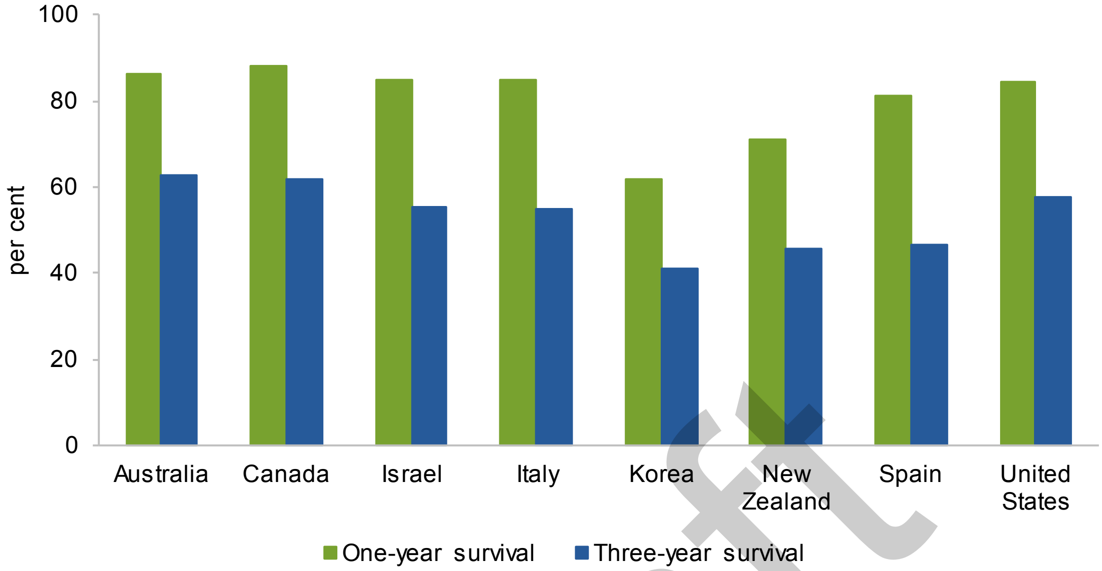


[a] The exit rate for employing businesses refers to the death of a business with at least one employee or the contraction of the business to have no employees as a proportion of all active businesses with at least one employee. It does not include mergers, split-offs or restructuring of a set of businesses. For Australia, business exits are not considered to have occurred when the business changes from having employees to no employees.

Source: ABS (2007, 2014d); OECD (2013a, 2014a)

New businesses in Australia tend to have a higher chance of surviving than those in other countries. Among new businesses set-up in 2006, those in Canada and Australia had higher rates of survival, while those in South Korea were least likely to survive. While this in part may reflect the onset of the global financial crisis (GFC), it does suggest that Australian set-ups remain active for a longer period of time (figure 2.9).

Figure 2.9 **New business survival rates, selected OECD countries[a,b]**
2007 to 2009



[a] Business survival rates as percentage of all employer businesses set-up in 2006. [b] The 3 year survival rate for Canada is for 2006.

Source: OECD (2013b); Industry Canada (2010)

2.2 What influences business set-up, transfer and closure?

Setting-up, transferring or closing a business is a major decision for the owners of a business. Along with personal considerations, this decision is influenced by a range of factors — such as economic conditions, attitudes to risk and innovation, competition and market structures and the regulatory environment (figure 2.10). There is also the role of technology which underlies a number of these factors.

Technology is enabling business set-up

Technologies, such as the Internet and app development, have reduced the barriers to setting-up a business (and enable the establishment of a business that supplements the owners' lifestyle). These technologies have accelerated the entrepreneurial process by reducing the fixed cost and capital requirements traditionally associated with setting-up a business. The potential market of a business set-up is no longer restricted by location or geographic boundaries — a product or service can now be sold to anyone with Internet access.

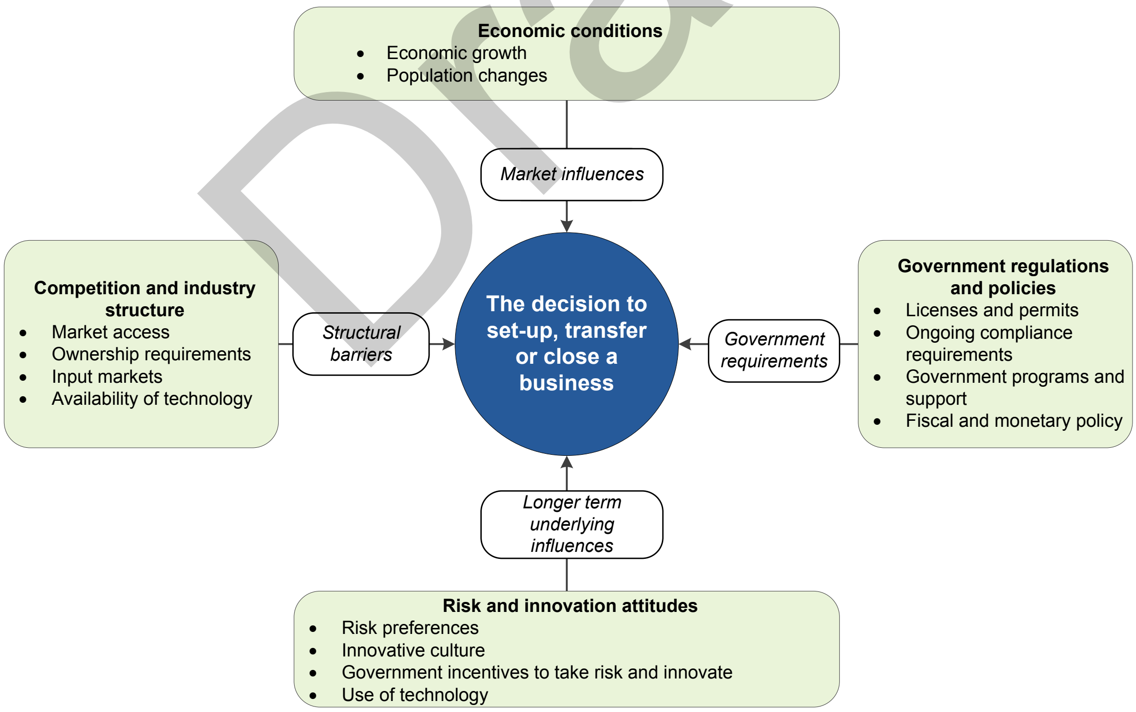
As noted by Google (sub 37):

> The distinctive qualities of the Internet are ease of access and decentralised control … The open nature of the Internet means that users, be they a new or established business, can generally create new applications, content or services that will be accessible by other users of the Internet without restriction or the need for approval. (p. 2)

Operating a business online allows an entrepreneur to reduce the potential risks of establishing a business by maintaining some form of employment, particularly during the early set-up phase. Similarly, digital technologies have allowed for flexibility around setting-up and operating a business. Increased flexibility, combined with economic and lifestyle considerations, has given rise to entrepreneurial mothers, sometimes referred to as 'mumpreneurs', which in turn has encouraged female workforce participation and increased the rate of female business ownership in recent years.

Technology has facilitated the development of new business models that meet consumer needs, increase capital/labour utilisation and lower prices. Some of these have also challenged existing regulatory arrangements (chapter 8).

Figure 2.10 **Factors influencing business set-up, transfer and closure**

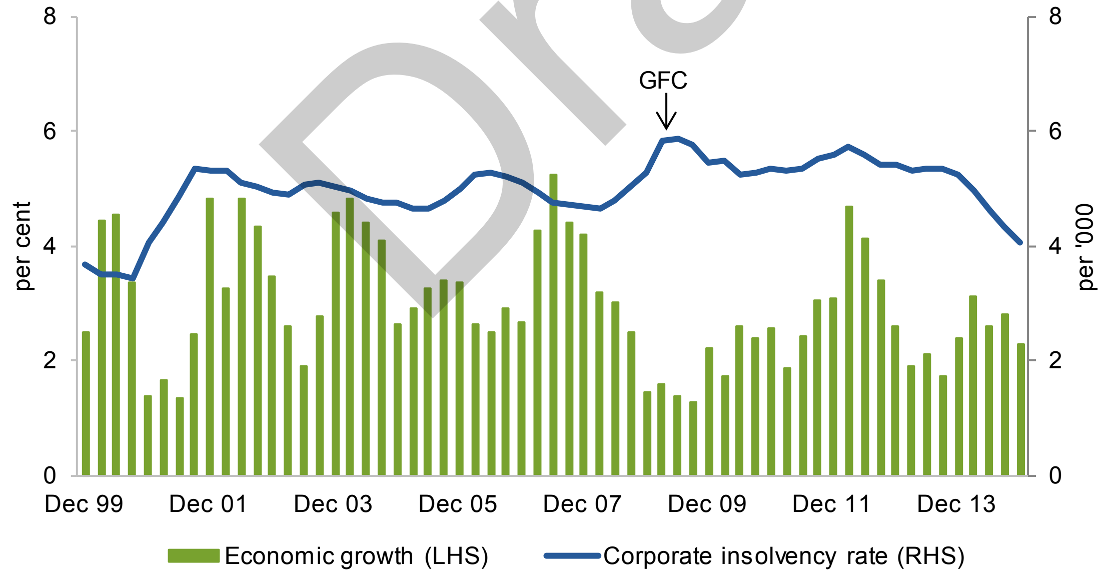


The impact of economic conditions

Macroeconomic conditions, such as economic growth and population changes, and broad government policy settings which affect the business cycle can have an overarching influence on business set-ups, transfers and closures. These factors are largely beyond the control of a business owner and can impact on specific industries or the economy as a whole.

Business closures generally move in line with the broader economic growth cycle, increasing during periods of slower growth and decreasing during periods of stronger growth. Corporate insolvencies have shown a counter-cyclical tendency in Australia — that is, insolvencies go up when the economy goes down (Connolly et al. 2015). The rate of corporate insolvencies peaked in 2008 following the onset of the GFC (figure 2.11). Despite this, business owners facing an economic downturn may delay closure or transfer in an effort to achieve a higher sale price when economic conditions improve. For example, farmers faced with drought have waited for conditions to improve and the value of their land to increase before leaving the industry (PC 2009c, p. 27).

Figure 2.11 **Economic growth and the rate of corporate insolvencies**[a]
Dec 1999 to Dec 2014



[a] Economic growth is the percentage change in real gross domestic product (GDP) for the last four quarters. The corporate insolvency rate is the number of insolvency appointments over the last four quarters for every thousand registered companies.

Source: ABS (2015b); ASIC (2014b, 2014d)

The relationship between business set-ups and economic growth is less clear. Some research suggests that lower demand during a recession inhibits the establishment of new businesses, leading to a pro-cyclical pattern (Bernanke and Gertler 1989; Rampini 2004).

Alternatively, higher unemployment during an economic downturn may drive the set-up of businesses as those unemployed seek to generate an income (Parker 2009; Thurik et al. 2008). Some of the latest analysis has suggested that set-ups in 109 countries have shown pro-cyclical tendencies between 2002 and 2012 (Klapper, Love and Randall 2014).

Population growth influences the rate of business set-up, transfer and closure by shaping consumer demand and the number of potential entrepreneurs entering the market. These changes can reflect national population growth trends or the shifts of population between specific areas. Variations in regional population growth rates have been a major factor behind differences in business formation in the United States. Areas with low rates of population growth have experienced slower levels of business set-up (Hathaway and Litan 2014).

Attitudes to entrepreneurialism and risk matter

Community attitudes to entrepreneurialism, risk and business failure have a longer term influence on the number of businesses being set-up, transferred and closed. The existence of an entrepreneurial culture can increase the establishment of new businesses. In such an environment, individuals are likely to be more willing to take risks, seek to develop new products and services and commercialise ideas. Attitudes to risk and innovation may vary between different segments of a community and between individual businesses. Some sectors of the economy, such as information and communications technology (ICT), are often perceived (not always accurately) as being more innovative than the primary and secondary sectors of the economy such as agriculture and mining.

Attitudes to entrepreneurial activity

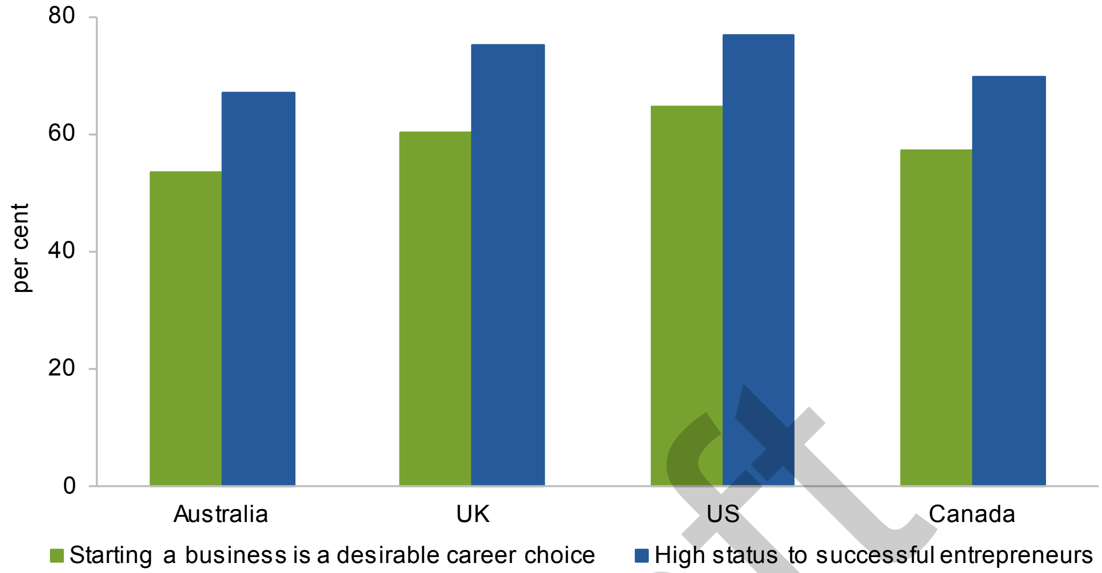
Societal factors and the characteristics of individuals shape community attitudes to entrepreneurialism and the likelihood of business ownership being selected as a career. Within the context of comparable countries, Australia does not perform well in terms of how entrepreneurialism is viewed by society.[3]

Starting a business as a career choice in Australia is viewed as being less desirable than in the United Kingdom, United States and Canada. Similarly, successful entrepreneurs are viewed more favourably in other countries than in the Australian community (figure 2.12). These cultural factors and indicators of entrepreneurialism within an international context are discussed further in chapter 11.

3 It is important to note that not all indicators of entrepreneurial activity are of equal weight. There is no objective basis for determining which indicator is most relevant to a particular policy or outcome. Similarly, the quality of data used to measure a country's performance varies by publication and indicator.

Figure 2.12 **Perceptions of entrepreneurial activity**[a,b]

Global Entrepreneurship Monitor comparisons



[a] Percentage of population aged 18-64 who agree with the statement that in their country 'starting a business is a desirable career choice' and 'that in their country successful entrepreneurs receive high status'. [b] Based on survey sample sizes of 2177 for Australia, 2007 for the UK, 3273 for the United States and 2479 for Canada.

Source: Singer (2015)

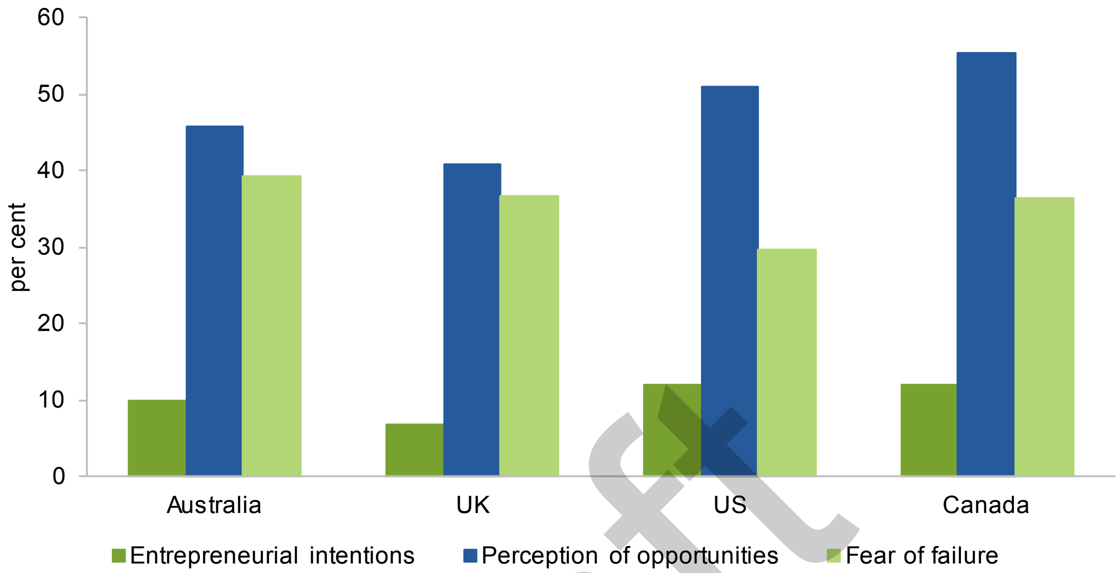
The intentions of individuals to start a business and the opportunities to do so vary across countries. For example, in Australia, intentions to start a business and the perceived opportunities in setting up a business are slightly lower than in the United States and Canada (figure 2.13).

Also, community attitudes to business failure can impede the scope of entrepreneurs 'trying again'. For example, societal views towards business failure may limit an entrepreneur from trying to establish a subsequent business or businesses. The fear of business failure acts as a greater barrier to establishing a business in Australia than in the United States. However, rates of 'fear of business failure' in Canada and the United Kingdom are similar to those in Australia. The degree of perceived penalty for failure under bankruptcy and insolvency laws can also affect the overall attitude to risk and entrepreneurial activity. These frameworks are discussed in chapters 13-15.

Similarly, social perceptions and a desire to maintain family ownership of a business may hamper small business transfer and closure. The transfer of business ownership and succession planning are discussed in chapter 12.

Figure 2.13 **Entrepreneurial attitudes[a,b]**

Global Entrepreneurship Monitor comparisons



[a] *Entrepreneurial intentions* is the percentage of the population aged 18-64 (excluding those currently involved in entrepreneurial activity) who intend to start a business within 3 years. *Perception of opportunities* is the percentage of the population aged 18-64 who see good opportunities to start a business in the area where they live. Fear of failure is the percentage of the population aged 18-64 who indicated that fear of failure would prevent them from setting up a business. [b] Based on survey sample sizes of 2177 for Australia, 2007 for the UK and 3273 for the United States and 2479 for Canada.

Source: Singer (2015)

There does not appear to be any particular personal characteristics which distinguish an entrepreneur. Generally, conscientiousness, openness, extraversion and emotional stability are viewed as being positively related to entrepreneurial intention and activity (Brandstaetter 2010). However, the overall effect of these personality traits on entrepreneurial activity is likely to be small, anyone who works hard to develop an innovative idea has the potential to be an entrepreneur. Similarly, the link between entrepreneurial education and the level of entrepreneurial activity is considered to be small (Fairlie, Karlan and Zinman 2012; Martin et al. 2013), but is dependent on the nature of the education. The role of personality and entrepreneurial education in determining entrepreneurial activity are discussed further in chapter 11.

Competition and market structures determine the economic viability of a business

Competition and the structure of an industry influences business set-ups, transfers and closures by determining the viability of the business. While most industry structures are beyond the control of governments and arise because of geographic and demographic factors, some are the direct result of government policies. For example, the Australian

Government's pharmaceutical benefits arrangements place particular restrictions on the locations and number of pharmacies able to participate in the scheme. Given the relative importance of the scheme to a pharmacy business, location and competition is effectively controlled. Generally, a new business would be able to earn higher net returns in less competitive markets than in markets comprising many businesses contesting for market share. The influence of government policies on entering and exiting different markets is discussed in chapter 10.

The structure of markets that provide labour, finance and other inputs to businesses and the price of these inputs can also influence business set-ups, transfers and closures. For example, the availability of finance is a critical input for all businesses and acts as an enabler of set-up and expansion. Access to finance for new businesses and issues with equity and debt finance are discussed in chapters 5 to 7.

The influence of the regulatory environment

Government regulations and policies shape what is needed to set-up, transfer and close a business. Regulatory requirements beyond that necessary to achieve regulatory objectives, (so-called 'red tape'), can act as a disincentive to business set-up. It has been broadly concluded that greater registration and regulatory requirements reduce the number of new businesses (Ciccone and Papaioannou 2007; Klapper, Love and Randall 2014).

Notwithstanding this, some regulatory requirements are necessary to meet legitimate policy objectives that ensure community safety. For example, certain businesses may require licenses or permits to provide specific goods and services. Measuring the burden of regulations on new businesses can be difficult. Quantity based indicators, such as the number of pages of legislation, can indicate the level of regulatory activity without regard to the benefits and costs of these policies (PC 2008c). The registration requirements for setting-up a business are outlined in chapter 3, while additional regulations faced by businesses in specific industries are discussed in chapter 10.

Government policies can also impede business transfer and closure. The existence of government support programs can act as a disincentive to transfer or close a poorly performing business. Alternatively, the availability of government support and subsidies can make it easier for businesses to get the necessary information, approvals and funding required to enter a market. The provision and operation of government assistance programs are discussed in chapter 11.

2.3 Why are business set-ups, transfers and closures important?

New businesses benefit the economy in a range of ways. Set-ups introduce new goods and services which increase consumer choice, improve the operation of existing markets and create new markets. They also place competitive pressures on existing businesses and can initiate new businesses models that change the manner in which goods and services are provided.

Business closures — particularly failures — involve costs that can be highly visible. This includes the personal impact on business owners, social impacts on the employees and the regions affected and financial impacts of losses for creditors, employees and owners, and costs in re-deploying the resources held by the business. Closure can influence product supply chains and impede the operation of related businesses. Further, the closure of businesses involves costs to government in the form of transition assistance and welfare payments, as well as the costs of organising and maintaining a regulatory system for orderly closures (box 2.2).

Such a wide range of costs could suggest that business failure and closure is a purely negative phenomenon. However this is a misperception, which ignores the somewhat less visible, but no less important role business closures play in a market economy by contributing to productivity growth, living standards and entrepreneurial learning.

Efficient business set-up, transfer and closure arrangements drive economic growth

The contribution of efficient business set-up, transfer and closure arrangements to productivity growth, higher incomes and improvements in community wellbeing is widely acknowledged (Gordon, Zhao and Gretton 2015; OECD 2001; PC 2009a; Syverson 2011). The rate at which businesses are set-up in part reflects the ability of the economy to innovate and try new processes and the rate of transfers and closures reflects the extent that less competitive businesses disappear (OECD 2013b, p. 196). The entry and exit of businesses ensures that scarce resources are put to their most productive use in the economy. As noted by the Business Council of Australia (sub 29):

> Efficient business entry and exit is fundamental to generating ongoing productivity increases and higher incomes. Business turnover facilitates the shift of resources in an economy from lower value to higher value uses. This occurs as the labour, capital and land released by declining businesses is re-employed by new or growing businesses and put to more productive use, including by merging or transferring some or all of their operations to another business. (p. 4)

Business entry and exit plays a crucial role in lifting the average productivity of an industry. Productivity improvements arise following the exit of less efficient businesses and the entry of more efficient businesses (OECD 2001). Evidence from developed countries shows that healthy market economies exhibit a high rate of business entry and exit (Foster, Haltiwanger and Krizan 2001).

Box 2.2 Ansett Airlines: an example of business closure in Australia

The collapse of Ansett Airlines is one of the largest business closures in Australia's history. The company was placed into administration in September 2001 with debts of $3 billion and operating costs of more than $200 million per month. The administration of the company was large and complex, involving the operations of 14 separate businesses (including regional airlines and travel agencies), 350 premises and a fleet of 133 aircraft under a variety of ownership and finance arrangements (KordaMentha 2002).

The direct impact of the closure was immediately apparent. Over 15 000 employees were out of work and faced uncertainty about where or when they would return to work. Ansett passengers had no planes to board, an estimated 47 000 people had tickets on the day flights ceased and competitor airlines attempted to fill the gap by offering discounted and free services (Goodsir and Doherty 2001). Airports had less traffic (around 30-40 per cent) over the following 3-4 months, as the closure combined with subdued aviation demand following the 11 September terrorist attacks in the United States (PC 2002).

The closure also had a broader and indirect impact on regional areas and complementary businesses. Some towns were without an air service where subsidiaries of Ansett were the sole operator of a route. Retailers who serviced airport terminals had reduced sales, particularly in Sydney following the closure of the Ansett terminal (Harley 2001). National sporting codes and stage shows faced logistical challenges and the reduced availability of flights led to the cancellation of a number of drama and dance tours (Leiper 2002).

In response, the Government introduced the Special Employee Entitlements Scheme for Ansett (SEESA) for former employees. The program included a $10 levy on Australian air passenger tickets to help fund the advanced payment of employee entitlements, but was not intended to relieve the company of its obligations. At the same time, the Government announced the establishment of the General Employee Entitlements and Redundancy Scheme (GEERS), the predecessor to the Fair Entitlements Guarantee (FEG), which provided assistance to employees involved in other corporate insolvencies (see chapter 15).

A long-term administration strategy was put in place to maximise the return to stakeholders as the value of aviation assets was depressed following the events of September 2001. While the conditional sale of the airline did not eventuate, the administrators managed the sale of various assets — terminals, aircraft and commercial properties — and ongoing businesses, such as the regional arms of the airline. The administration was finalised after 10 years, with employees receiving, on average, 96 cents in the dollar of their entitlements (KordaMentha 2011).

In the years since the closure, the reallocation of Ansett resources has improved the operation of the Australian aviation industry. While there were many aspects to the reallocation process, its contribution to industry change was exemplified by the freeing up of Ansett terminals, which allowed 'common use' by new and expanding carriers, especially Virgin Australia, Jetstar and Tiger Airways (Kain and Webb 2003). Consumers have benefited from these structural changes, with airfares declining in real terms and the number of people traveling by air doubling between 2001 and 2015 (BITRE 2015).

Australian studies generally show that business entries and exits have contributed to aggregate productivity growth. Generally this arises through the exit of less efficient businesses, as set-ups can take an extended period to reach the efficiency level of established businesses (Breunig and Wong 2007; Nguyen and Hansell 2014). However, Bland and Will (2001) determined that productivity improvements of established businesses made the most important contribution to productivity growth.

Some of these studies have highlighted differences across industries. For example, Nguyen and Hansell (2014) concluded that productivity improvements following business set-up and closure were more pronounced in business services than manufacturing. Relative to operating businesses in each industry, entering businesses were found to be of similar productivity levels in manufacturing and business services, whereas exiting businesses in manufacturing were relatively more productive than those in business services. The chances of business survival were similar in both industries.

The transfer and closure process also facilitates changes in the structure of the economy as the demand for, and the cost of supplying goods and services in specific industries changes over time. Entries and exits can also facilitate adjustment within industries to favour more efficient means of production. For example, the structure of the Australian agricultural industry has changed in response to a range of external pressures — including the globalisation of markets, new technologies and changing consumers tastes (PC 2005b). These factors have driven the transfer and closure of smaller farms, as Australian agriculture has moved towards fewer and larger farms which have been shown to be more efficient and more likely to use innovative production techniques (Sheng et al. 2015).

Barriers to transfer or closure can prolong the continued operation of inefficient businesses which may be unable to sufficiently maintain physical or environmental assets. The degradation of these assets can generate additional costs for other potential users and for society as a whole. For example, a struggling business may not adequately maintain and repair capital equipment which places additional restoration costs on subsequent users. A rural business in decline may crop or stock land at an intensity that over time degrades soil quality and possibly limits the use of that land in the future.

Set-up, transfer and closure enables the process of 'creative destruction' — a term coined by Schumpeter (1942) to describe how entrants with new products and technologies compete with industry incumbents. If the set-ups technology or business process succeeds, they replace the incumbents. If not, they decline and exit the industry. Successive waves of innovation through set-up and closure can allow for the creation of completely new markets and industries of higher value than those that were replaced. For example, innovations such as cars, personal computers and electronic devices have replaced previous industries and have benefited consumers through higher quality products and increased convenience.

Allowing entrepreneurs to learn and experiment

Business set-ups and closures encourage the progressive development of new and innovative business models by allowing entrepreneurs to learn and experiment over time. There are several aspects to this process:

- *Learning by doing* — entrepreneurs gain experience from the business set-up process and learn how to undertake business differently (and better) next time. Business owners who have previously set-up and closed a business have been shown to have an increased likelihood of success with their next business (Lafontaine and Shaw 2014). Entrepreneurial experience is particularly important in high tech industries. New ventures are more likely to be publicly listed when the entrepreneur already has a successful business or has previously failed (Gompers et al. 2010). The economy can only benefit from this experience if those involved are willing to try again, and are not dissuaded by additional requirements to set-up or excessive (legal or social) sanctions for failure.
- *Information* — for outside observers contemplating starting a business, closures provide information on consumer demand and risk in particular industries or geographic areas.
- *Transfer of skills* — closures can allow for the broader diffusion of specialist skills as employees find work in other businesses. However, the closure of a business may also involve the loss of managerial knowledge and skills possessed by some owners and employees (Bickerdyke, Lattimore and Madge 2000, p. 4).

3 Setting up a business

Key Points

- The generic registrations needed to set up a business are relatively straight forward and generally speedy. There are no major concerns about their operation.
- A number of concerns have been raised with the operation of specific licensing and approvals that are required by some new businesses. These, and other matters relating to business interactions with regulators on set-up and during operation, have been the subject of recommendations and findings by the Commission and others in the past. While progress has been made in a number of areas, particularly generic business registration and establishment, many of these issues remain unaddressed, particularly by state, territory and local governments.
- Ongoing compliance issues are a major concern for business, particularly in the areas of taxation and employment obligations. These compliance burdens can dissuade new business entrants, stymie business expansion or hasten closure.
- While individual regulatory processes might be relatively simple, there is the scope for a significant cumulative burden of regulation and regulatory processes on business to develop.

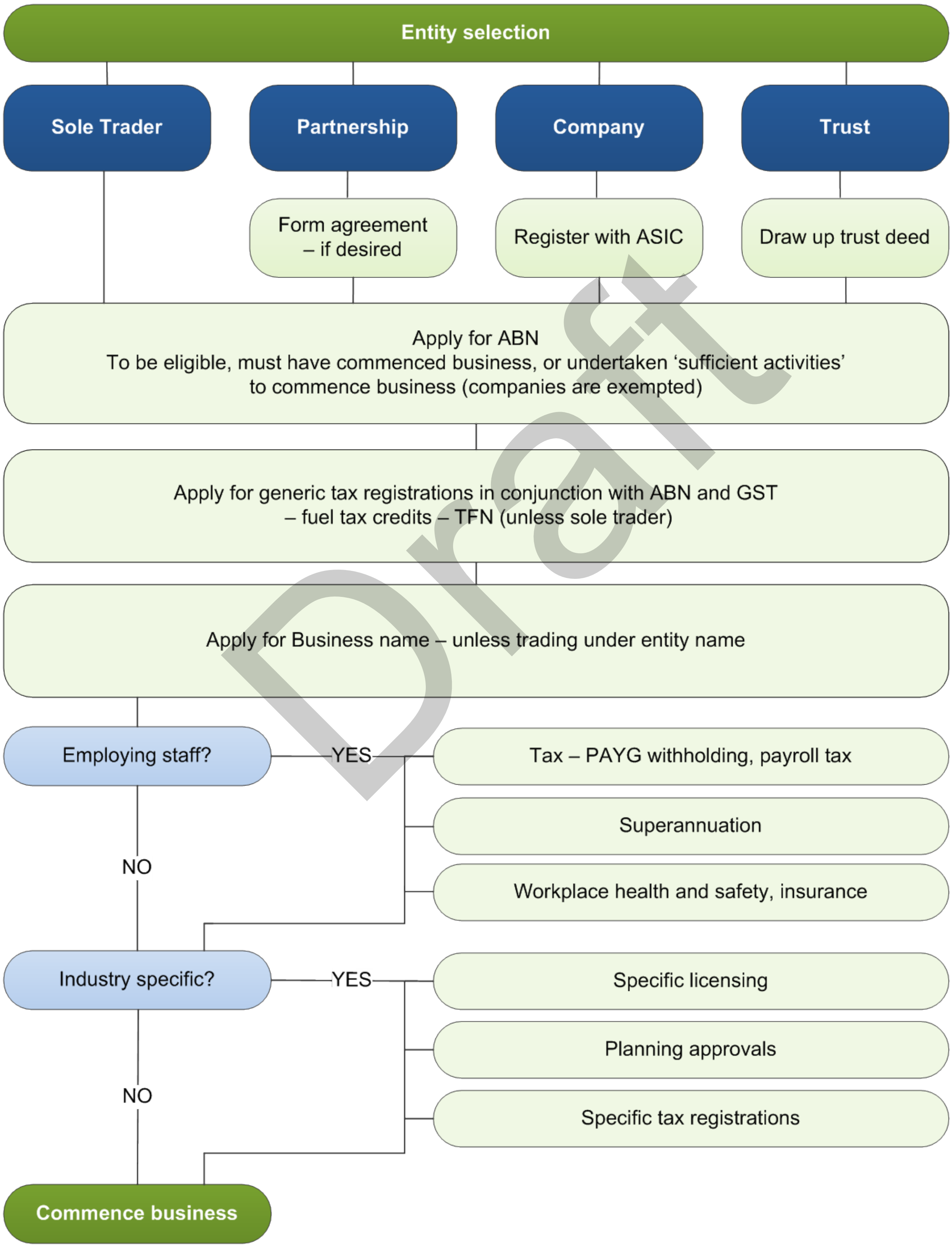
This chapter examines the process of setting up a business and the regulatory requirements that must be satisfied before a business can commence. Regulatory requirements may be generic and apply to all businesses or specific to the nature of the proposed business activity — some industries have significant regulatory requirements for entry.

These regulatory arrangements and requirements (or ‘red tape’) can act as a disincentive to setting up a business if they create costs that are unnecessarily high to achieve regulatory objectives, and/or are overly complex, and discourage would-be business people. Of course, some regulatory requirements may be necessary to meet a government’s legitimate policy objectives. For example, certain businesses may be required to be licensed and/or registered before commencing trading to protect community safety. This raises issues as to whether there are alternative mechanisms that would meet the policy objectives of government and reduce or remove the disincentive to set-up a business.

3.1 Generic requirements for setting up a business

The generic requirements that apply when setting up a business are illustrated in figure 3.1. Many of the regulatory requirements apply to all or most businesses, irrespective of their activities, location or business structure. Some requirements only apply to those businesses that employ staff. There are also some processes that, while not strictly regulatory in nature, are often necessary to commence operating in a particular sector/industry.

Figure 3.1 **Regulatory steps for setting up a business**



Setting up the legal structure of the business entity

There are four main entity types that are used in Australia to set-up and run businesses — sole trader, partnership, company and trust. Some businesses use a combination of entity structures for different elements of the business.

Depending on the choice of structure, there may be a number of steps that must be undertaken before applying for an Australian Business Number (ABN) and other generic business and tax registrations.

- Sole trader — as there is no separate entity, there are no initial requirements before applying for an ABN.
- Partnership — there are no initial legal requirements to set up a partnership and the process can be commenced with the ABN process.
- Company — as a company is a separate legal entity, it must be created in the first instance. This involves an application and payment of the prescribed fees to ASIC to register the company. Companies are then allocated an Australian Company Number (ACN). While this needs to be done before other business registrations, there are streamlined processes for other registrations, such as an ABN and, if required, a business name.
- Trust — to create a trust, a trust deed needs to be drawn up. A trust deed may need to be stamped by the relevant state revenue office and duty may be payable. The trustee can then apply for an ABN and other registrations on behalf of the trust.

Further details on each of the entity types and issues around their use for conducting business are discussed in chapter 4.

Australian Business Numbers

Australian Business Numbers (ABNs) were introduced on 1 July 2000 as part of the suite of changes to the tax system associated with the introduction of the goods and services tax (GST). The ABN is a unique 11 digit number used to identify a business. It is publically available and can be accessed through the ABN Lookup website, which provides details for each ABN including the entity name, entity type and whether it is registered for GST.

The range of entities issued an ABN is broader than just actively trading business, and includes entities (companies and trusts) used for passive investment purposes and superannuation funds. Other entities that may be allocated an ABN include government departments and agencies, not-for-profit organisations and associations. As at June 2014, there were around 7.7 million entities with an ABN. This is around three times the number of active businesses estimated by the Commission (chapter 2).

Applying for an ABN

An ABN can be applied for either on a paper-based form or online. There is no charge when applying for an ABN. To complete the application for an ABN, the applicant will need to provide details such as:

- the legal name of the entity
- tax file number (TFN), if already issued
- Australian Company Number (ACN), if using a company structure
- business activities and locations
- contact details, including tax agent details
- any previously held ABNs

The application process also includes a series of questions aimed at determining eligibility for an ABN. These act as a vetting process and need to be answered 'correctly' for an ABN to be issued. To be eligible, the applicant must have their business structure in place and be carrying on an enterprise, or have undertaken sufficient activities to commence an enterprise. (This does not apply to applicants that are companies, as these entities are automatically eligible for an ABN.)

Most online applications are successfully completed, and an ABN is issued immediately. Delays can occur for reasons such as failure to provide a tax file number (TFN), which is used as an identity check for individuals, or where the applicant has previously had an ABN.

There are a number of other, primarily tax related, business registrations that can be completed along with the ABN process, through the Australian Business Register website, including:

- GST, fuel tax credits and pay as you go (PAYG) withholding for the taxation of employees
- AUSkey, which is used by businesses to login to online government services
- business names
- TFNs for entities other than individual sole traders.

Of these, registering a business name is the only registration that incurs a fee.

Business name registration

A business name is a name that a business trades under. It identifies the business to customers and provides a link to the ABN (this can be publically searched on the ABN Lookup website). A business name is not required if the business trades under the entity name, that is, the full name of the company or trust, a sole trader's first name and surname, or the names of all members of a partnership.

Business names are registered with ASIC. There are streamlined processes for registering a business name at the time of an ABN application. Otherwise, it can be undertaken at a later date through the ASIC Connect website (business names cannot be registered before an ABN is applied for). There is a fee charged for business name registrations of $34 for one year or $78 for three years.

The current national business name registration process commenced in 2012. Prior to this, business or trading name registrations were administered by the states, meaning a business had to individually register its trading name in each jurisdiction it traded in. At the commencement of the new system existing state registrations were migrated to the national register. The move to a national system was undertaken as part of the COAG *National Partnership Agreement to Deliver a Seamless National Economy*, which was agreed to in 2008 and included a range of business regulation reforms.

An important point to note about business name registration is that it does not confer any type of proprietary rights over the use of that name. To ensure exclusive use of a name, a business would need to register that name as a trademark with IP Australia.

Other regulatory requirements

A range of other requirements can apply at set-up — some of which are generic in terms of business activity, but only apply to businesses with certain characteristics. Employing staff is perhaps the most common trigger of additional regulatory requirements. Many businesses start small, with no employees, so the obligations that come with employing staff are associated with business expansion rather than set-up. For businesses employing staff at the outset, employment-related regulations can act a barrier to entry, especially if the business expects to employ a significant number of staff at the commencement of operations.

Tax

Starting a business involves a range of new tax obligations and concessions, many of which require the business to register for the tax when commencing business. For most of these — GST, fuel tax credits, PAYG withholding — businesses can complete registrations in concert with their application for an ABN, as noted above. There are also more specialised registrations — such as the luxury car tax and wine equalisation tax — that are only required for specific business activities. A new business might also choose to voluntarily enter the PAYG instalment system. On-going businesses are generally required to make regular payments during the year towards their expected tax liability. This does not apply in the first income year of operation as there is no tax liability history for that business, but a business can elect to make nominated instalment payments.

If a business is to have employees there will be additional registrations and subsequent obligations required of the business, primarily the PAYG withholding requirements for remitting income tax amounts on behalf of employees to the ATO. If the business intends to provide fringe benefits to its employees it will also need to apply for this registration.

Payroll tax

While most of the tax registrations required by new businesses are for Commonwealth taxes administered by the ATO, a business will be liable for state/territory payroll tax if its total Australian wage bill exceeds the designated thresholds. The thresholds and tax rates vary by state/territory. Thresholds (on an annual total wage bill basis) range across jurisdictions from a low of $550 000 (Victoria) to a high of $1 850 000 (ACT), while the tax rate varies across jurisdictions from 4.75 per cent (Queensland) to 6.85 per cent (ACT). A business will need to separately register for payroll tax with the state revenue office in each jurisdiction where its wage bill exceeds the threshold.

Some harmonisation of payroll tax was achieved under the COAG Seamless National Economy reforms. This related to alignment of a range of legislative provisions other than thresholds and tax rates, such as the timing for lodgement of returns, as well as measures to increase administrative consistency and cooperation between state revenue offices.

Superannuation

Analogous to the requirement for employers to submit income tax payments on behalf of eligible staff, employers are required to make payments to the superannuation fund of their employees. There are some exemptions with super contributions not required for employees (over 18 years old) whose earnings are below $450 dollars a month. Employees under 18 years must also work a minimum of 30 hours per week to be eligible.

Superannuation contributions of at least 9.5 per cent of an employee's ordinary time earnings must be paid to the superannuation fund on a quarterly basis by the specified cut-off dates.

Businesses are required to offer employees a choice of superannuation fund. Employees are provided with a *Standard choice form* — those that do not elect a fund have their contributions paid to a fund nominated by the employer.

Businesses with 19 or fewer employees can elect to use the Small Business Superannuation Clearing House, a free online superannuation payments service for small businesses that allows them to make all of their superannuation payments to the clearing house, which then distributes them to the employees' nominated superannuation funds.

While the issue of whether someone is an employee or a contractor is an important one in working out the tax and employer obligations for a business, even if an individual is considered a contractor for tax purposes, the business may still be liable to make superannuation contributions on their behalf. This additional liability arises where the contract is wholly or principally for the supply of labour.

Another issue is that while sole traders or members of a partnership are not employees and therefore not subject to superannuation guarantee obligations, there are provisions available for these business owners to make superannuation contributions if they wish.

Broader employment obligations

There is a range of additional obligations on businesses that employ staff. This may include:

- compliance with the relevant awards and employment contacts
- record keeping obligations, including the provision of pay slips
- provision of a safe workplace for staff and compliance with workplace health and safety regulations.

Non-regulatory processes that can be part of set-up

In addition to the regulatory requirements for setting up a new business, there are numerous other processes that new businesses undertake when setting up. Some of these are briefly listed below. The Commission does not have evidence of significant concerns or issues in these areas, nor that there is scope or need for government intervention.

- *Professional services*. Setting up a business may involve the engagement of service providers such as lawyers and accounts/tax agents. While not strictly required for simple business and tax affairs, these services are commonly used, particularly where more complex business structures are employed.
- *Domain names*. As noted above, registering a business name does not provide full protection for that name (a business would need to register a trade mark to provide additional protections for the name). Another common step would be to register the business name, or variations thereof, as internet domain names.
- *Banking and finance*. A new business will likely require a range of banking services. At the most basic this would involve transaction accounts, although separate accounts are not strictly required for those operating as sole traders. New businesses may also require various payment facilities (such as card terminals) and finance. These issues are discussed more fully in later chapters.
- *Insurance*. There are a range of insurances that a business may obtain, such as public liability cover and insurance of business assets. Insurances such as these may not be strictly required in a regulatory sense. However, some insurance, such as workers compensation or various indemnity insurances may be a regulatory requirement of employing staff, or being granted a licence or approval to operate.

Are the generic set-up requirements too onerous?

In general, the generic requirements to set up a business do not appear to represent a serious impediment to setting up a business. In part, this is a reflection of some the recent reforms to streamline requirements, such as the nationalisation of business name registrations, or through improved information provision to prospective business owners, such as through the *business.gov.au* website.

However, that is not to say that there are not some concerns and areas where improvements could be made to streamline and better coordinate the set-up process. There is a view, represented in some submissions to this inquiry, that setting up a new business can be a difficult or frustrating experience, especially for new small business operators.

For example, the Australian Small Business Commissioner said:

> Commencing and registering a new business is often a frustrating experience for small business operators. The process involves interaction with multiple Commonwealth agencies that use different terminology and have different processes and timeframes.
>
> Feedback received by this Office has revealed:
>
> - Information is spread over multiple websites that are difficult to navigate;
> - Agencies have different registration processes and requirements;
> - The same information has to be entered multiple times; and
> - Applications can generally take up to 28 days to process. (sub. 10, p. 4)

ACCI also noted the array of requirements on new businesses. They also raised the specific issue of delays with the new business name register:

> There are a broad range of regulatory requirements associated with starting a business. For instance, under the new national business name registration system, business names need to be registered with ASIC. Businesses have reported difficulties and delays in registering names since the commencement of the national system. (sub. 11, p. 11)

Concern was raised by the Australian Trucking Association about the issue of when prospective businesses are able to obtain an ABN.

> Essentially, individuals cannot obtain an ABN unless they are carrying on an enterprise or have taken significant steps to commence one, such as signing contracts, issuing invoices or purchasing equipment. In many cases, though, an individual cannot do these things without already holding an ABN. (sub. 13, p. 8)

The Australian Trucking Association went on to say that:

> Australian Business Number (ABN) arrangements should be amended to allow individuals to register for an ABN with the intent of carrying out an enterprise (sub. 13, p. 8)

Conversely, the general lack of concern about the generic requirements was also reflected in some submissions to this inquiry. For example, Business Enterprise Centres Australia submitted:

> Other [than local government planning] regulations that have a major impact on business are becoming less obvious. The nationalisation of the business names register, the ease with which an ABN and a TFN can be obtained is a pleasant surprise to many of the Asian business intenders we assist … A well managed business with up to date bookkeeping will be able to complete BAS and IAS statements easily and quickly. Slack bookkeeping procedures will result in these tasks taking a great deal of time. (sub. 4, p. 3)

And, the Chamber of Commerce and Industry Queensland noted the improvements in information provision to new businesses:

> CCIQ recognises the Federal Government's efforts to streamline access to business related information (specifically the business.gov.au service) and encourages the government to continue reform in this area to include service delivery. (sub. 8, p. 4)

This last point also reflects that information provision and regulator engagement practices have as much to do with a business's experience of regulation as does the regulation itself. A point made in the Commission's recent study into *Regulator Engagement with Small Business* (PC 2013e). That study found that there is scope for some improvement in regulator engagement practices, including that communications need to be more responsive to business needs and capacities. It also found that more widespread use could be made of formal cooperation arrangements between regulators.

ASIC informed this inquiry that it has adopted a range of initiatives to reduce regulatory barriers to business, noting:

> The following ASIC initiatives are examples that have reduced or removed the regulatory barriers to business including starting up or acquiring a business:
>
> (a) improving our guidance and communication, including the launch of a new online hub dedicated to small business;
>
> (b) improving the AFS licence application process;
>
> (c) simplifying business names registration; and
>
> (d) issuing regulatory guidance and relief from the law to reduce the regulatory burden for business. (sub. 20, p. 4)

On the issue of business name registration, ASIC noted:

> Businesses can apply to register or renew a business name online any time, including after business hours, and in most cases receive confirmation of their registration straight away. As a consequence, 99.9% of business name registrations are completed online and costs for registering a business name have come down. …
>
> We estimate that ASIC's Business Names Register has already saved business over $79 million in reduced fees to register or renew business names, in its first two years of operation. We expect that it will save business over $209 million in its first five years. (sub. 20, pp. 5-6)

The Australian Business Register, in its administration of the ABN application process, has also developed it processes over time. The addition of a questionnaire to determine ABN eligibility at the beginning of the ABN application process, as well procedures to reduce clerical errors has increased the proportion of applications that are completed immediately.

3.2 Requirements applying to specific business activities

In addition to generic regulatory requirements that generally apply to all businesses, there are specific requirements that exist for businesses engaged in particular activities and industries. Specific regulatory requirements are much more likely to represent an impediment to setting up business than the generic requirements discussed above. These requirements can involve obtaining licences, registrations or approvals to operate the business, acquiring relevant re-zoning and development approvals, establishing the required reporting systems and having the appropriately qualified staff employed in or operating and managing the business. The nature of these requirements varies enormously by industry and often involves dealing with multiple regulators from the Australian, state and territory and local governments.

While many of these processes may generate significant net social benefits, some can impose excessive and unnecessary regulatory burdens on business and impede business set-up. Generally, these impediments to business set-up can be classified as either location specific (planning and zoning), or requirements specific to the business activity (licensing and approvals).

Location requirements

Planning, zoning and development regulatory processes can represent a major barrier to, and impose significant time and monetary costs on, new business set-ups. This has been raised as an issue by a number of participants to this inquiry. For example, the Australian Property Institute submitted:

> … the regulations to establish a new business often require the seeking of relevant development consent and even a rezoning of land prior to the seeking of development consent. (sub. 2, p. 4)

And, the Small Business Development Corporation submitted that:

> … poor planning and development processes can have significant and long-term impacts on the viability of many small businesses and contribute to higher operating costs. (sub. 28, p. 5)

Planning, zoning and development assessments have been the subject of a previous review by the Commission (PC 2011a). In that study, the Commission found that:

- Planning systems vary greatly across the states and territories. Significant differences in state and territory planning systems include the degree of integration between planning and infrastructure plans, and how capably the states manage their relationships with, and guidance for, local councils.
- The success of local councils in delivering timely, consistent decisions depends on their resources as well as their processes. It is also influenced by the regulatory environment created by state governments.

- There are significant differences between jurisdictions in the imposts on business, including costs such as the median time taken to assess development applications and the extent of developer charges for infrastructure.

The Commission subsequently identified a number of leading practices around these issues (see box 3.1).

Box 3.1 Previously identified planning and zoning leading practices relevant to business set-up

Many of the Commission's previous recommendations and leading practices related to business set-up have not been fully implemented. As an example, the Commission has undertaken numerous studies that have covered planning and zoning issues, which can be a significant impediment to setting up a business

Leading practices in the 2011 report on *Planning, Zoning and Development Assessment* included:

- strong commitment to engage the community in the structural planning of cities with less engagement then required for each development proposal
- broad and simple land use categories to: reduce red tape, simplify assessment processes and reduce the need for rezoning, enhance competition, help free up urban land for a range of uses and give a greater role to the market in determining what these uses should be
- rational and transparent rules for charging new infrastructure costs to businesses
- development assessment processes that are risk-based and electronic
- clear timeframes and coordination for referrals of development proposals to government agencies with greater transparency and accountability in these assessment processes
- limited appeal provisions for rezoning decisions
- limited objections and appeals for developments that are consistent with the local land plan, with particular controls on the use of objections by businesses to reduce competition.

Some of these were broadly reiterated in the 2012 *Local Government as Regulator* study, which also identified leading practices around:

- periodic assessment of the stock of local and state regulation to reduce the overall burden on businesses
- a gateway approach to guard against local governments imposed costly requirements for building standards that are inconsistent with the relevant national or state codes
- enabling the licencing of businesses (such as mobile food vendors) in one local government area to be recognised in all local government areas in that state
- greater use of risk based approaches for business compliance inspections
- graduated review and appeal systems for local government decisions and processes.

More recently, in the 2014 study into the *Relative Costs of Doing Business in Australia: Retail Trade*, the Commission again identified 'planning and zoning regulations that are complex, excessively prescriptive, and often anticompetitive' that still needed to be addressed, although it was noted that there had been some progress in Victoria.

Source: PC (2011a, 2012a, 2014e)

While some states have undertaken reforms to parts of their zoning and development assessment processes in recent years, it appears that there remain substantial impediments to business entry. As the Australian Property Institute noted:

> In its 2011 report, the [Productivity] Commission stated that planning, zoning and development assessment was a hindrance to business entry and remains so to date. (sub. 2, p. 4)

State and local governments should continue to improve their processes, in line with the leading practices previously identified by the Commission, in order to meet regulatory objectives in a way that minimises the burdens and barriers imposed on business.

Business-specific approval requirements

Business or industry specific approvals, licences and accreditations are the other main regulatory impediment to setting up a new business. A number of submissions to this inquiry have raised concerns around the difficulty imposed by licensing type requirements. These concerns have included issues around the requirement for multiple licenses and duplication across different levels of government. For example, Master Electricians Australian submitted that:

> … the average contractor needs no fewer than six worker licenses and two business licenses in order to commence trading.
>
> There are substantial amounts of duplication in the criteria for these licenses, and the processes for applying and maintaining each and every license has become extreme. …
>
> In addition, there are numerous different state and federal, private and Government bodies that have to be engaged with to monitor and achieve a fully licensed outcome. With national occupational licensing no longer being pursued by government the issue of licensing continues to be a significant barrier to the set up of an electrical contracting business. This is particularly so for those businesses operating across state lines. (sub. 6, p. 1)

Similar sentiments were also echoed about regulation in the food sector, with Restaurant and Catering Australia submitting that:

> The restaurant, café and catering sector is a highly regulated sector, subject to multiple layers of regulation at a federal, state and local government level. The biggest areas of regulation occur around the provision of food, the service of alcohol, and the labour intensity of the sector …
>
> There are multiple licenses and approvals required to operate a restaurant, café or catering business which can form a significant barrier to entry. The requirements of each license and approval may vary significantly from jurisdiction to jurisdiction. (sub. 21, pp. 5-6)

While these licensing requirements often have legitimate public policy goals, the cumulative burden of regulations can be oppressive and potentially create barriers to new businesses entering highly regulated industries. These issues have been recognised by governments. The Australian Business Licence and Information Service (ABLIS), for example, has been established to provide a single portal that can inform businesses about licence requirements.

The impact of regulation on businesses in some industries has been the subject of previous review by the Commission. For instance, the Commission has previously examined food safety regulation (PC 2009d). In that study, the Commission noted that local councils play a key role in the administration and enforcement of consumer food safety regulation, and that there are significant differences in councils' fees and charges, inspection rates, enforcement practices and transparency of their activities, which can lead to unnecessary costs and uncertainty for new businesses.

The role of local government as a regulator was further examined by the Commission in a subsequent study (PC 2012a). Local governments are a significant source of potential regulatory burden on new businesses as their role can cut across both development application issues and the issue of licenses, permits or registrations. Further, decisions affecting businesses are often made under local laws and quasi-regulatory instruments that are not always subject to as much consultation in design as state or Commonwealth regulation. Another major problem is the lack of capacity of local governments to administer regulatory roles delegated to them by state governments. The review identified a range of leading practices that could be more widely adopted to improve the capacity of local governments as regulators, improve consistency and minimise the burdens on businesses at set-up and in ongoing operations. Governments should ensure that there is progress in this area, given the significant role of local government regulation in some industries.

DRAFT RECOMMENDATION 3.1

Governments, particularly those at a state, territory or local level, should fully and promptly implement the leading practices and recommendations from the Commission's previous reports on business regulation, including:

- *Performance Benchmarking of Australian Business Regulation: Cost of Business Registrations* (2008)
- *Performance Benchmarking of Australian and New Zealand Business Regulation: Food Safety* (2009)
- *Performance Benchmarking of Australian Business Regulation: Occupational Health and Safety* (2010)
- *Performance Benchmarking of Australian Business Regulation: Planning, Zoning and Development Assessments* (2011)
- *Performance Benchmarking of Australian Business Regulation: The Role of Local Government as Regulator* (2012)
- *Regulator Engagement with Small Business* (2013)

3.3 Ongoing and cumulative compliance burdens

The ongoing regulatory requirements or compliance costs involved in operating a business include annual reporting requirements to regulators and governments, workplace relations and employment requirements, taxation obligations and the renewal of registrations, approvals and/or licences. To the extent that ongoing compliance costs are known and are excessively high, they could act as a disincentive to establish a business, or contribute to a business's decision to exit. Further, they are the main source of concerns about regulatory burdens raised in submissions to this inquiry, for instance:

> ACCI's Red Tape Survey 2014 indicates that a large portion of businesses (42.8 per cent) surveyed reported that complying with Government regulatory requirements has a moderate negative impact on their business. This was followed by over one fifth (21.6 per cent) stating that compliance has a significant negative impact on their business. Together, 64.4 per cent of businesses believe regulatory compliance has a negative impact on their operations. Only 3.4 per cent of respondents noted it has a significant positive impact. (sub. 11, p. 10)

Similarly, the Chamber of Commerce and Industry Queensland noted that regulations could act as a barrier to new business start-ups and entrepreneurship:

> … business start-ups must be afforded additional consideration when developing regulatory processes, to ensure that the business operating environment is conducive to business start-ups.
>
> … Poorly formulated and implemented regulation can act as a barrier to entry and expansion by exposing business start-ups to excessive compliance costs and stifling market competition. When regulation is over complex, prescriptive, redundant or duplicates the regulation of other jurisdictions and regulatory bodies, innovative and lower cost approaches to meeting intended outcomes are effectively prevented. (sub. 8, pp. 3-4)

Often, there is no one regulatory requirement that acts as a particularly egregious barrier to the set-up of new businesses. Rather, it the cumulative effect of set-up requirements, specific licensing and approval requirements and ongoing compliance obligations that can make undertaking business less attractive and potentially stymie new entrants.

Master Builders Australia provided one example of the cumulative burden of regulation:

> Regulation, whether 'red' or 'green' tape, is a significant burden on the BCI, [building and construction industry] which is one of the most intensely regulated in Australia, with regulation imposed by all three tiers of government. …
>
> Anecdotal evidence provided to Master Builders by our rank-and-file members indicates regulations add between eight and twelve per cent to the cost of construction of the average Australian residential dwelling. (sub. 33, p. 16)

The two main areas of concern about the burden of regulatory compliance on business relate to tax and employment obligations.

Tax compliance burdens

While there are range of obligations imposed on new businesses in terms of tax registrations, running a business involves a range of ongoing compliance obligations. For many businesses, particularly those in lightly regulated sectors, and those without employees, tax obligations could be the predominant form of regulatory burden.

This extent of tax compliance burdens was noted in numerous submissions. For example, National Australia Bank noted it was a significant source of compliance that often required specialist assistance:

> Taxation is a key consideration and requirement for businesses of all size and a significant source of compliance. … The technical nature of some tax requirements means SMEs – many of whom may have had limited previous business or finance experience – are often required to engage specialist external assistance (e.g. accountants) or invest significant amounts of time understanding their requirements in order to become compliant. (sub. 7, p. 13)

Similarly, the Small Business Development Corporation noted that:

> Survey after survey reveals that tax compliance reporting remains a significant issue and cause of stress for many small business operators in Australia. It goes without saying that this burden is most pronounced at the smaller end of business operations (i.e. sole traders and micro-enterprises employing less than five staff) due to the limited resources (both financial and time) and/or expertise of business operators to ensure compliance with their reporting requirements. (sub. 28, p. 3)

Taxation, both in terms of compliance burdens and the actual rates of taxation are major issues that affect business, including influencing decisions to set up new businesses. Tax impediments facing small businesses were recently reviewed by the Board of Taxation (box 3.2). It will also be a feature of the forthcoming White Paper on the Reform of Australia's Tax system. In the initial discussion paper for the white paper process, issues were flagged around both the corporate tax system (including the corporate tax rate, dividend imputation and the utilisation of losses) and small business taxation, including issues such as complexity, compliance burdens, and available tax concessions (The Treasury 2015b).

The extent of tax compliance burdens will also be affected by the choice of business structure. This is covered in more detail in chapter 4.

Box 3.2 Small business tax impediments

The Board of Taxation in its recently released report into small business tax impediments made recommendations for improvement or further review in the following areas:

- eligibility for an ABN and other ABN application issues
- greater access to ATO assistance
- determination of employee versus contractor relationships
- personal services incomes issues
- the need for quarterly reporting/combined BAS tax return
- aligning the taxable payments reporting system (TPRS) reporting date with the BAS
- transfer pricing guidance for small business
- raising the small business turnover threshold to $3 million, and investigating the feasibility of $5 million
- quarterly superannuation obligations assessment
- superannuation guarantee issues, including:
  - changes to calculating the charge
  - deductibility of charges
  - reporting
  - late payments
- lifting the minor and infrequent FBT threshold from $300 to at least $500
- investigating the possibility of aligning the FBT year to the income tax year.

Source: ATO (2014)

Workplace relations

The compliance obligations, and costs, associated with employing staff under Australia's workplace relations system may also act as a barrier to businesses setting up or expanding.

For example, Ai Group claimed in its submission that:

> The Fair Work Act 2009 (FW Act) operates as a barrier to business start-ups and investments through a lack of flexibility and overly prescriptive provisions.
>
> Problems include:
>
> - The requirement that greenfields agreements for new undertakings and projects can only be entered into with union/s.
> - An excessive amount of power given to unions in the bargaining process.
> - The outlawing of statutory individual agreements which played an important role in delivering flexibility to employers and employees while they were available between 1996 and 2009.

> - The ability for unions in unionised workplace to, in effect, veto Individual Flexibility Arrangements (IFAs) providing any meaningful flexibility.
> - In assessing whether an IFA meets the Better Off Overall Test, the Act should make it clear that the preferences of employees for particular work arrangements should be able to be taken into account.
> - Overly prescriptive provisions in the 122 modern awards.
> - The system of 4 Yearly Reviews of Modern Awards which encourage unions to pursue a raft of costly and unproductive claims every 4 years, which take the next 4 years to defend until the whole process starts again.
>
> A large proportion of Australian businesses which compete with overseas companies have a major cost competition problem. In order to encourage businesses to invest in Australia, our workplace relations system needs to be far more flexible than it currently is. (sub. 27, p. 20)

The Institute of Public Accountants also considered that compliance obligations hindered employment by small businesses:

> The reluctance by small businesses to employ people is attributable to compliance obligations imposed on entities associated with employment such as PAYG, Superannuation Guarantee Charge, FBT and workers compensation, which impose substantial costs and when combined with other nontax regulations impose disincentives to employing staff. (sub. 32, p. 39)

They subsequently suggested that there is a case for concessional tax treatment for small businesses due to 'the highly regressive nature of compliance costs on small business' (sub. 32, p. 39).

However, there is a counter view. In its submission to the Commission's inquiry on workplace relations, the Australian Council of Trade Unions submitted that:

> The Fair Work Review Panel was unable to establish that the FW Act had increased compliance costs for business. It notes that it was not presented with any persuasive evidence of onerous compliance costs, when compared with earlier legislative frameworks.
>
> To that end, it is unlikely that compliance costs in the industrial relations system have any significant impact on employment rates. Compliance costs are necessary, and in many cases unavoidable. Whilst the instability of legislative reform has in the short term increased compliance costs due to the need to adjust to new or changed regulatory requirements, in the longer term, the national system has reduced the overall compliance costs associated with doing business. (ACTU 2015, p. 83)

The Commission is currently exploring the implications of Australia's workplace relations system on businesses (among others) in a concurrent inquiry into the workplace relations framework.

Minimising the overall regulatory burden on business

While regulatory requirements often have legitimate public policy reasons, particular regulations may be redundant, or could be modified to achieve regulatory objectives in a less costly way.

This fact is not lost on governments. For example, the Tasmanian Government submitted that:

> Increasing regulation and its growing complexity can act as a barrier to business entry. Regulation can also stifle entrepreneurship, innovation and impede the growth of businesses.
>
> The Tasmanian Government recognises the burden regulatory requirements place on businesses and is working to reduce Tasmanian-based red and green tape by 20 per cent in its first term.
>
> The Tasmanian Government has recently completed a comprehensive Regulation Reduction Audit, which identified all State based regulations specifically impacting on businesses. The audit found that the industries that are carrying the heaviest regulatory burden in Tasmania are:
>
> - agriculture
> - forestry
> - fishing
> - retail trade transport, and
> - manufacturing. (sub 18, pp. 4-5)

Similarly, the Australian Government has committed to audits of regulators, using a framework developed by the Commission, with respect to the compliance costs that they impose on the businesses they regulate. All Australian governments have 'red tape' reduction proposals and targets to stem the expansion in the stock of regulation, although progress has been mixed.

In addition to the effects of regulations themselves, the approach of regulators in their engagement and implementation practices can also add to the compliance burden of regulation. In its recent study on regulator engagement with small business (PC 2013e), the Commission noted that effective engagement depended on a range of factors, including: regulator culture; tailored communication practices; a graduated approach to compliance monitoring and enforcement, including have discretion and accountability measures; and adequate resourcing. Governments should continue to ensure that frameworks are in place to facilitate regulators adopting the leading practices identified by the Commission in that report.

Regulators also need to be able to adapt to regulatory challenges that arise with the evolution of business models. This issue is discussed in further detail in chapter 8.

4 Business structures

Key Points

- There is a range of potential structures that can be used to set up new businesses. The four main structures are sole traders, partnerships, companies and trusts.
  - Of the actively trading businesses, as measured by the ABS, companies are the most common form of structure chosen, followed by sole traders, trusts and partnerships.
  - Over the past 5 years, the numbers of businesses operating through companies and trusts have increased, while the numbers of operating sole traders and partnerships have declined.
- The choice of business structure is determined by the interplay of a host of factors. such as asset protection, liability, succession, profit or loss distribution, and tax management. These factors underpin the increasing popularity of trusts for business use, despite their complexity and inherent lack of suitability. It is also why complex business structures are so widely used — the use of different entity types allows the business to capture the advantages of the different structures.
- The taxation of businesses, and the distortions created by the differing tax regimes, should be examined in the White Paper on the Reform of Australia's Tax System.

A critical aspect of setting up a business is the choice of structure — different structures vary markedly in terms of the regulatory burden at set up, ongoing regulatory and reporting requirements, tax treatment, implications for future capital raisings, equity or ownership options, legal liabilities and ease of closing. This creates incentives to choose particular structures and can create distortions in the economy.

4.1 Different business ownership structures

There are four basic forms of business structure — sole traders, partnerships, companies and trusts. There are also a number of other, less common, entity structures.

Sole traders

A sole trader is the simplest business structure, with few legal and tax formalities. It is the easiest and least expensive structure to create. Accordingly, it a very common choice of structure for businesses across most industry sectors, particularly for businesses at the micro or small end of the scale.

To operate as a sole trader, an individual applies for registrations, such as for an Australian Business Number (ABN), goods and services tax (GST) and fuel tax credits in their own name (although they may also register a business name) and uses their personal tax file number (TFN). Business income, after claiming allowable deductions, is included in an individual's personal tax return, along with any other income, including a salary or wages, and assessed for income tax purposes using the personal income tax rates. Notably, if the business makes a loss, this can be offset against other income, subject to some restrictions.

A sole trader cannot be an employee of their business, that is they cannot pay themselves a wage in the traditional sense. Accordingly, they are not subject to employer obligations, such as payment of superannuation or workers compensation premiums, in respect of themselves, although they may choose to mimic these requirements.

Partnerships

A partnership is where two or more people (or other entities, such as companies) carry on a business as co-owners. A partnership is relatively inexpensive to set up and operate. A normal partnership is not limited in the number of members and there is no registration required. A partnership may have a formal partnership agreement, but it is not essential. A partnership may be implied by a court.

Because they are relatively inexpensive to set-up, they are commonly used for smaller businesses, often for family businesses. At the larger end of the scale, a common use of partnerships is for professional services firms.

To operate as a partnership, the partners apply for registrations such as an ABN and GST in the partnership's name. The partnership also needs a separate TFN, which can be applied for in the ABN process.

A partnership operates as a 'flow-through' structure for tax purposes, similar to a sole trader. Income and losses are shared among the partners in the prescribed shares. Each partner's share of the income is included in their personal tax return. Again, as with sole trader's, a partner's share of losses can be potentially offset against other income.

Partners are also not employees of the business, so any monetary drawings from the business by partners are not considered as deductible wages for tax purposes.

An important feature of a standard partnership is that each partner is responsible for all the liabilities of the partnership. However, there are some specialised forms of partnership that can be used to vary this.

A limited partnership is a more flexible form of partnership that allows for two types of partners. General partners operate the business and have unlimited liability, as per the partners of a standard partnership. Limited partners are passive investors in a business, whose liability is limited to the amount invested in the partnership. Limited partnerships are regulated by the states and are required to be registered with the relevant state authorities.

A further variation is an incorporated limited partnership. This is a separate legal entity providing further liability protections for partners. It is also administered and registered at the state level. Incorporated limited partnerships are restricted to use for venture capital investment.[4]

Companies

An incorporated company, regulated under the *Corporations Act 2001* (Cth) by the Australian Securities and Investments Commission (ASIC), is a distinct legal entity, meaning that it can enter into contracts, including purchasing property, and be involved in legal action in its own right. This is in contrast to a sole trader or partnership, where there is no legal distinction between the business and owners as individuals.

A company is owned by shareholders and administered by directors. Shareholders are the owners of the company and their liability in this capacity is typically limited. Operation of the company is the responsibility of the directors (and management). Directors may also be shareholders — for example, a proprietary company could have a single director and shareholder — or be professional directors appointed to a board. Directors are required to act in the interests of the company and have a range of fiduciary duties, including ensuring that the company is solvent (see chapter 14).

Compared to sole traders or partnerships, a company is a relatively complex business structure, with more regulatory and administrative costs due to additional reporting requirements to a separate regulator. There are also prescribed annual fees that are paid to ASIC to register a company.

There are different types of companies. The primary distinction is between proprietary and public companies. Proprietary, or private, companies have lower obligations in terms of the number of directors required (a minimum of one), but are also limited in the number of shareholders allowed (limited to fifty). On the other hand, public companies require more directors, but are less restricted with respect to shareholders and raising equity.

Companies can also vary in terms of the liability of members (the shareholders). For companies limited by shares, when a company is wound up the liability of shareholders is limited to any unpaid amounts (often there are none) owing on their shares. For companies limited by guarantee, members do not need to contribute any capital while the company is operating, but are liable for the amount they have agreed to contribute, as per the

4 In addition to being registered under state legislation, incorporated limited partnerships for venture capital purposes need to be registered under the *Venture Capital Act 2002* (Cth) in order to access concessional tax treatment.

company's memorandum of association, if the company is wound up. A company might also be limited by both shares and guarantee. A company can also be registered as an unlimited company, where there are no limits on the liability of members. This is essentially an incorporated partnership. Finally, there are no liability companies, where there are no legal obligations on shareholders to pay calls on unpaid amounts still owing on shares. This option is limited to mining companies only.

Most companies are proprietary companies limited by shares, accounting for almost 99 per cent of the 2.1 million currently registered companies.[5] Public companies, including those that are listed on stock exchanges, are generally larger than private companies, but are relatively few in number. There are around 6600 public companies limited by shares, of which 28 per cent are listed companies. There are almost 15 000 public companies limited by guarantee (these are mostly not-for-profit organisations). The other types of companies are even less common. There are just over 200 companies limited by both shares and guarantee, and just over 300 companies (predominately proprietary) with unlimited liability. No liability companies are also relatively uncommon, comprising just 140 registered companies, as at 1 April 2015.

To commence business as a company, the company must first be registered with ASIC. This can be achieved by lodging a form with ASIC, or through a range of third party service providers. Upon registration, the company is issued an Australian Company Number (ACN). The company can then apply for an ABN and TFN, and register for GST if required.

A company acts as an accumulative structure for tax purposes. It submits its own tax return and net income is taxed at the flat corporate tax rate of 30 per cent. Profits can then either be retained within the company and used for company purposes or distributed to shareholders as a dividend. Dividends are included as income on a shareholder's individual tax return, along with a credit for the company tax already paid. Losses, however, cannot be distributed to shareholders, but are retained in the company and offset against future income. Another difference in the taxation of companies is that companies are not eligible for the 50 per cent discount on capital gains tax for assets.[6]

Trusts

A trust is an obligation imposed on a person or entity (the trustee) to hold property or assets for the benefit of others (the beneficiaries). The operation of the trust is set out in a

5 Not all currently registered companies are actively trading businesses.

6 The discount, subject to eligibility (such as holding an asset for at least 12 months), is available for sole traders (the same as for individuals in general) and for the flow-through entities of partnerships and trusts. Another point, is that the ineligibility for the discount is for assets sold by the company as an entity. Where capital gains are accrued in the corporate structure and the shares of the company are subsequently sold, the shareholder may be eligible for the discount.

trust deed. Setting up a trust can be relatively complex and expensive, as a formal deed is required. There are also formal yearly administrative obligations on the trustee.

There are various types of trusts and they have a long standing history of use in common law countries, having typically been used as a passive vehicle for holding assets. Their use for active trading purposes is a more recent phenomena. The main distinction in trusts is between discretionary and fixed trusts. With a discretionary trust, the trustee can distribute income between beneficiaries in an unrestricted manner. In a fixed trust, each beneficiary is entitled to a fixed share of the distributed income. In some fixed trusts, such as a unit trust, beneficiaries are allocated units in a trust which can potentially be traded in a similar manner to shares. The relative composition of the different type of trusts is illustrated by the number of trusts lodging tax returns for 2012-13 (table 4.1). Discretionary trusts used for trading accounted for around a third of all trusts that submitted tax returns.

Table 4.1 **Number of trusts by type[a]**
2012-13

	Number
Discretionary trust-main source from investment	315 418
Discretionary trust-main source from service-management	39 521
Discretionary trust-main source from trading	254 511
Cash management unit trust	653
Hybrid trust	9 275
Fixed unit trust	86 931
Other fixed trust	16 919
Public unit trust-listed	367
Public unit trust-unlisted	4 536
Deceased estate	49 220
Other	2 756
Total number of Trusts	**780 105**

[a] Based on those trusts that submitted a tax return for 2012-13.

Source: ATO (2015)

To commence business through a trust, once the trust is created by the trust deed, the trustee must apply for a TFN and ABN for the trust. Other registrations, such as GST can also be undertaken if required.

Trusts act as flow-through structures for tax purposes. Net income from the trust is passed through to beneficiaries. The beneficiaries then declare their trust income along with any other personal income on their individual tax return. Where all net income is distributed to Australian resident adults, there is no tax liability. If net trust income is retained in the trust, it is taxed at the top marginal tax rate. Also, the trust will be liable to pay tax on distributions made to either non-residents or minors. While a trust distributes net income, losses cannot be distributed to beneficiaries. There are also rules on the treatment of losses within the trust that determine if they can be offset against future income.

One of the key features of discretionary trusts is that the trustee can determine the proportion of income that is distributed to each of the beneficiaries. This presents the opportunity to distribute income to those beneficiaries with less income from other sources and so minimise the aggregate level of income tax paid by the beneficiaries as a group. Similarly, streaming rules permit differences in the allocation of income and capital gains (meaning that capital gains could be allocated to those beneficiaries that can offset them against other capital losses they have incurred).

Other entity structures

There are other entity structures, such as cooperatives and associations, that can also be used to carry on a business, or business-like activities. A business activity might also be carried on as a 'joint venture', although this is not strictly a separate type of entity structure.

Cooperatives

As with a company, a cooperative is an incorporated structure that is a distinct legal entity. It is administered by directors who have similar responsibilities to those of company directors. However, it is operated for a slightly different purpose. While a company is operated to provide a financial return to shareholders, a cooperative is operated to benefit its members, usually through the provision of goods or services.

To form a cooperative, there must be a minimum of five members. The purpose and way in which a cooperative operates is set out in its rules. This includes rules for membership, which may require contribution of share capital or the payment of subscription fees. A key principle of cooperatives is democratic member control, all members have equal voting rights. A cooperative can set up as either distributing or non-distributing. Distributing cooperatives can distribute profits or surplus funds to members. Non-distributing cooperatives, which cannot distribute profits, are likely choices for community-type organisations. Members' liability is limited to either share capital or paid/owed subscription fees.

Cooperatives are registered and regulated by the states and territories. A Cooperatives National Law is being progressively adopted by the jurisdictions to provide for uniform regulation of cooperatives across jurisdictions (NSW Fair Trading 2015b).

Cooperatives for business purposes are relatively commonly used in agriculture, often as a means of providing processing and marketing services to members. Cooperatives are a relatively infrequent structural form, compared to the main business structures noted above. For example, there are approximately 640 cooperatives in New South Wales (NSW Fair Trading 2015a), not all of which are business-related, out of around 700 000 total businesses in that state. While relatively uncommon, cooperatives can be economically significant businesses. Nationally, the largest cooperative is the Western Australian-based grain handler, Co-operative Bulk Handling Ltd, which recorded sales of $3.9 billion in 2014. Other large cooperatives include Namoi Cotton, Norco (a dairy processor) and Dairy Farmers.

Associations

Associations are not-for-profit organisations that are run for the benefit of members or the broader community. They can be run as an unincorporated entity, or they can be incorporated, under state regulations, which allows the entity to enter contracts in its own right, including to engage employees, and provides additional protections for members.

State-based incorporation as an association is an alternative to incorporation under the *Corporations Act 2001* (Cth) typically suited to smaller not-for-profit organisations that only operate in one state.

Joint ventures

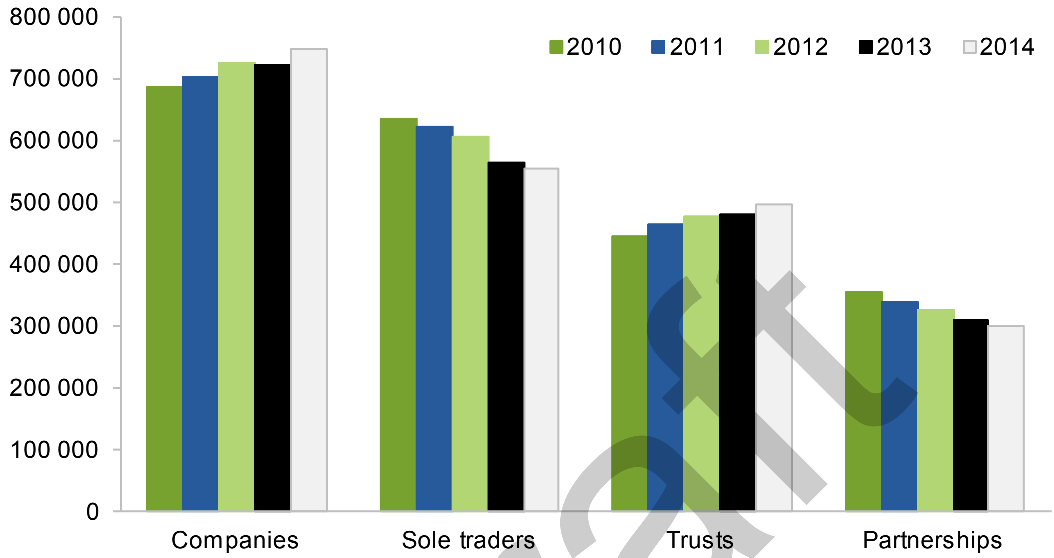
While not strictly a form of business structure in its own right, business activities are often carried on by multiple parties who come together to undertake a particular enterprise as a joint venture for mutual gain. The legal or financial form of a joint venture is not fixed and could be undertaken in a number of ways. For example, a joint venture may be just a contractual agreement between a number of parties. Alternatively, it could involve the creation of a partnership, or a new incorporated entity. The scope for the use of joint ventures is broad — examples include instances where land or resource owners partner with firms to provide capital or labour inputs to develop that resource such as mining, share farming and residential or commercial property development. Joint ventures can also play a role in foreign investment.

4.2 Prevalence of different structures

Over the past 5 years there has been relatively little change in the total number of businesses in Australia. In June 2014, there were around 2.1 million businesses in Australia, as reported by the ABS (Cat. No. 8165.0) — this count excludes around 54 000 not-for-profit businesses and micro businesses (including around 460 000 sole traders) that are not registered for GST.

Using the ABS count, companies accounted for 36 per cent of the total number, followed by sole traders (26 per cent), trusts (24 per cent) and partnerships (14 per cent). However, there have been differing trends depending on entity type (figure 4.1). The number of businesses operated through a trust has increased each year over the period 2010 to 2014. Companies have also generally increased in number over time, save for a slight decrease in 2013. Conversely, partnerships have continually declined in number over this period. The number of sole traders, which, to date, has remained the second most common form of business structure, has also been declining over time, with a substantial decline in numbers in 2013.

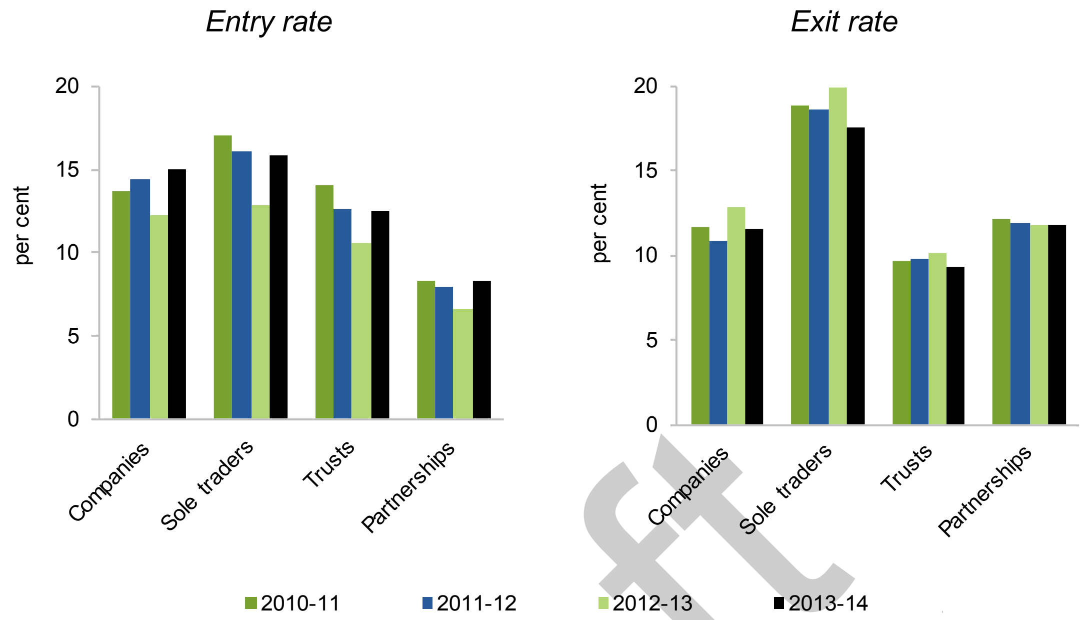
Figure 4.1 **Australian private sector businesses, by entity type**
Number operating at 30 June



Source: ABS (2015c)

The changes and trends in the stock of operating businesses by entity type from one period to the next is a function of both the rate of entry and exit (figure 4.2). Sole traders have the greatest churn and have consistently had the highest entry and exit rates. This may be a reflection of the relative ease and low cost of set-up, making them the default choice in the case of ill-conceived business set-ups. Overall, there is little discernible trend in entry and exit rates over time, aside from a slight increase in the entry rate for companies and a slight decrease in exit rates for sole traders. The year 2012-13 is a distinctive outlier with markedly lower entry rates and generally higher exit rates. As observed in changes in the stock data above, entry rates for companies and trusts have consistently exceeded exit rates, while exit rates have consistently exceeded entry rates for sole traders and partnerships.

Figure 4.2 **Entry and exit rates, by entity type**



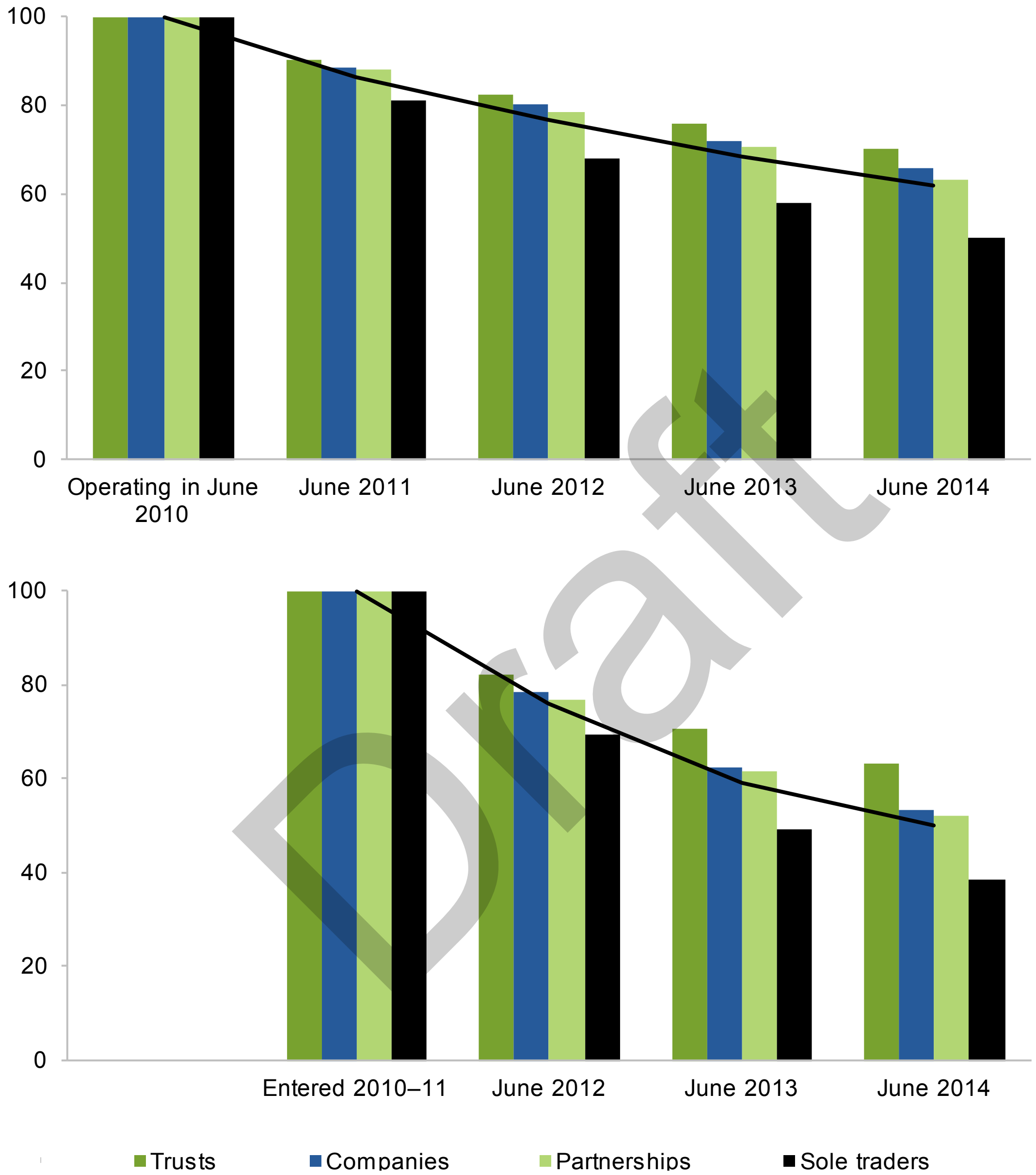
Source: ABS (2015c)

A similar story is observed in the survival rates, by entity type, of those businesses that were operating as at 30 June 2010 (figure 4.3). Survival rates are highest for trusts, followed by companies, partnerships and then sole traders. The latter is substantially lower. For more recent business entries (those commencing business in 2010-11), there is a more marked difference in the survival rate between different entity types, although the biggest annual decrease in business survival occurs in the first year for all entity types.

At the broad level, it is interesting to note that the more complex the business structure, the longer it is likely to survive. However, this does not necessarily mean that business structure per se affects longevity, rather it is likely that businesses intended for shorter operational periods (including a large array of micro businesses) are more likely to be set up under a sole trader structure, while many set up as trusts will have a purpose of asset allocation or tax minimisation (in the case of discretionary trusts).

Figure 4.3 **Survival rate of businesses, by entity type[a]**

Per cent of businesses still operating



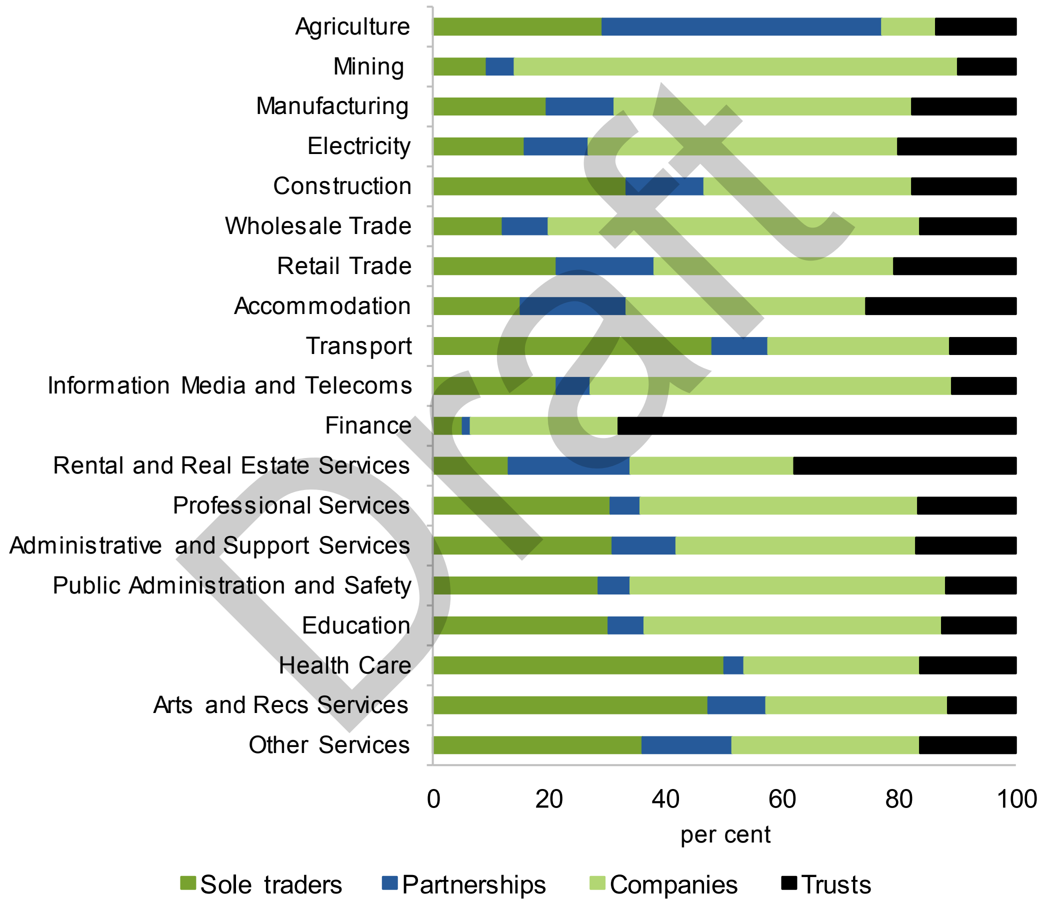
[a] Black line is the average of all entity types.

Source: ABS (2015c)

Business structures by industry

There is some variation in the prevalence of different business structures across industries (figure 4.4). Sole traders are most common in industries such as transport and health care. Partnerships are the most popular business structure in agriculture, while companies are particularly prevalent in mining. Trusts are most prevalent in the finance and real estate industries.

Figure 4.4 **Business structure shares by industry**

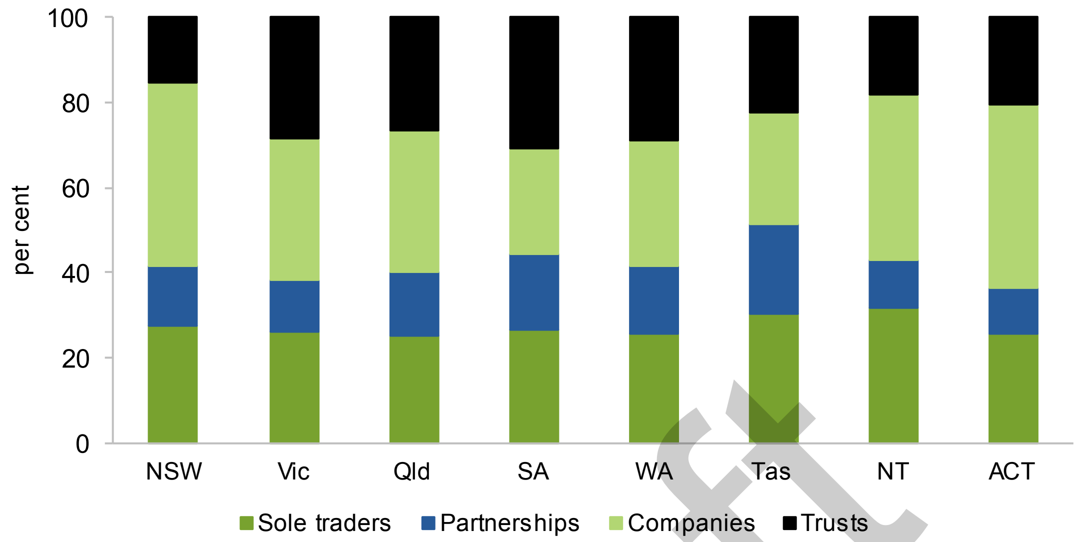


Source: ABS unpublished

Business structures by jurisdiction

There are some differences in the use of business structures by jurisdiction (figure 4.5). The most obvious of these is the relatively higher use of companies and lower use of trusts in New South Wales.

Figure 4.5 **Business structure shares by jurisdiction**
Per cent



Source: ABS unpublished

4.3 Incentives in choosing a business structure

Each entity structure comes with different tax, liability, and compliance obligations. These differences can influence the structure chosen for setting up a new business, including the establishment of complex business structures that combine different entity types in order access the different advantages of each type.

Factors that may be considered in choosing the most appropriate business structure can be broadly categorised as: ownership and business purposes; administrative and compliance burdens; taxation; and limiting liability and asset protection. Other considerations, such as financing, may also be important.

Ownership

Broadly speaking, firms can be owned and/or managed by either capital or labour. The choice of this depends on the purpose of the business. Where the business is intended primarily as a vehicle for deriving returns on capital, a corporate model is chosen with a company controlled by shareholders (that is, capital) — for example, mining or manufacturing companies. However, a business, particularly at the smaller end of the spectrum, might be established for reasons other than improving returns on capital, such as improving the owner’s labour earnings, or as a means of providing employment for their associates or family. That said, the choice of business structure is likely to be a result of a range of technical administrative and tax-related considerations rather than just the business purpose.

The choice of business structure will also depend on the intended number of owners and anticipated life cycle of the business, including any plans for the future growth, sale, transfer or disbandment of the business. If there is only a single owner, then the business may be formed under any available legal structure. If there is to be more than one person with an equity stake in the business then a structure other than sole trader will be required. For a small number of active business participants a partnership may be used, while a company structure may be more appropriate where ownership is to be spread amongst a broader group or there is the intention to access equity finance.

Business exit plans are also an important consideration in choosing a structure. Company structures allow for relatively easy transfer of ownership, as the business is a discrete entity that can be sold. Trusts are often used for family businesses, especially in the agricultural sector, as a means of continuing business over different generations. Sole traders and partnerships are less conducive to wholesale ownership transfer as the business is not a discrete entity, but provide a degree of flexibility to people that may be considering retirement or a return to full-time employment elsewhere in the economy.

Reporting and compliance burdens

The choice of business structure has a marked effect on the type and amount of regulatory requirements and the associated compliance burdens. A sole trader has relatively low compliance costs, while a company structure involves additional reporting to another regulator (ASIC).

For many setting up businesses, particularly at the micro level where capital inputs are relatively low, more complex structures may be inappropriate, unnecessary, or otherwise not provide additional benefits that exceed additional compliance burdens. The complexity of more sophisticated structures, particularly trusts, and the associated increase in the need for specialist professional advice (such as accountants and lawyers), may also act as a barrier to some businesses being set up under a different structure that could otherwise be more advantageous. Potentially, these barriers may be one reason why new business entrants in recent years are dominated by sole traders.

Tax

As noted above, there are fundamental differences in the taxation treatment of businesses operating under the different entity types. This can mean that different structures will be more tax effective, depending on the stage of the business and the financial circumstances of the business owners.

- If the business is expected to run at a loss in the early years of operation, a sole trader or partnership structure would allow the business owners to offset losses against other income. This may be particularly attractive if the business is a relatively small or speculative start-up being financed by other paid employment. This model has many similarities to negatively geared investment properties.
- If the business is a family business and there are numerous related individuals with otherwise low levels of income and hence low marginal tax rates (such as adult children at university), then a discretionary trust structure can be used to distribute income so as to minimise tax obligations.
- If it is intended to use income from the business for expansion purposes, then a company structure may be appropriate, as earnings are taxed at a flat 30 per cent, as opposed to personal tax rates of up to 49 per cent.

Capital gains tax (CGT) liability incurred when a business is sold or transferred can also influence the choice of structure. This is discussed further in chapter 12.

In the Australian Government's 2015-16 Budget, a range of concessional tax initiatives were announced as part of a Jobs and Small Business package. These measures include: a two-year increase in the threshold (from $1000 to $20 000) for an immediate tax deduction for purchased assets; allowing the immediate deduction of start-up costs for new businesses; a reduction in the corporate tax rate of 1.5 per cent for companies with annual turnover under $2 million; a 5 per cent tax discount for unincorporated businesses with annual turnover under $2 million; and CGT rollover relief when a business changes legal structure, but ownership remains the same. The introduction of these measures may alter the relative incentives affecting the choice of legal structure for new businesses.

Legal liability and asset protection

Liability and asset protection are common reasons for the selection of certain business structures. Under a sole trader structure, there is no distinction between the business and operator, meaning that the proprietor is personally liable for all debts incurred by the business. In a partnership, partners are personally liable for all debts of the partnership, which can make a partnership a potentially riskier business structure.

More complex structures can limit liability. Under a company structure, shareholders' risks are limited to their shareholding in the company. However, there are a number of legal obligations imposed on company directors (see chapter 14). The primary one is to not allow insolvent trading. If the company does trade while insolvent then directors are liable to a range of civil penalties, compensation proceedings and criminal charges. Directors may also increase their liability though the use of director guarantees. These are commonly used by small companies to access finance, whereby the director uses personal property, such as their home, as security.

Trusts are similarly used to limit liability, as beneficiaries are not liable for debts incurred by the trust. However, the trustee can be personally liable for the debts of the trust. A common method to provide an additional layer of protection is the use of a corporate trustee. Trusts are also used for asset protection. For example, in a family business, trusts may be used to maintain control of assets and prevent the breakup of a group of assets, while still providing a financial benefit to a range of family members. Trusts might also be used by business owners to hold non-business assets, such as their home, beyond the reach of business creditors.

Other factors

Choice of structure might also be determined by commercial requirements. For instance, other businesses or customers, including governments, may only be willing to deal with an incorporated entity for certain business transactions. Similarly, investors, including overseas investors, may be more comfortable investing in a business structured through a company rather than a trust as it is a more familiar structure in many countries.

Combinations of business structures

Each of the different legal structures under which businesses can be established offer their own set of advantages and disadvantages. Businesses are often set-up using a combination of different entities and entity types in order to access the taxation or liability benefits of particular structures, and reduce liability risks by isolating elements of a business within a separate entity. As noted by the Institute of Public Accountants:

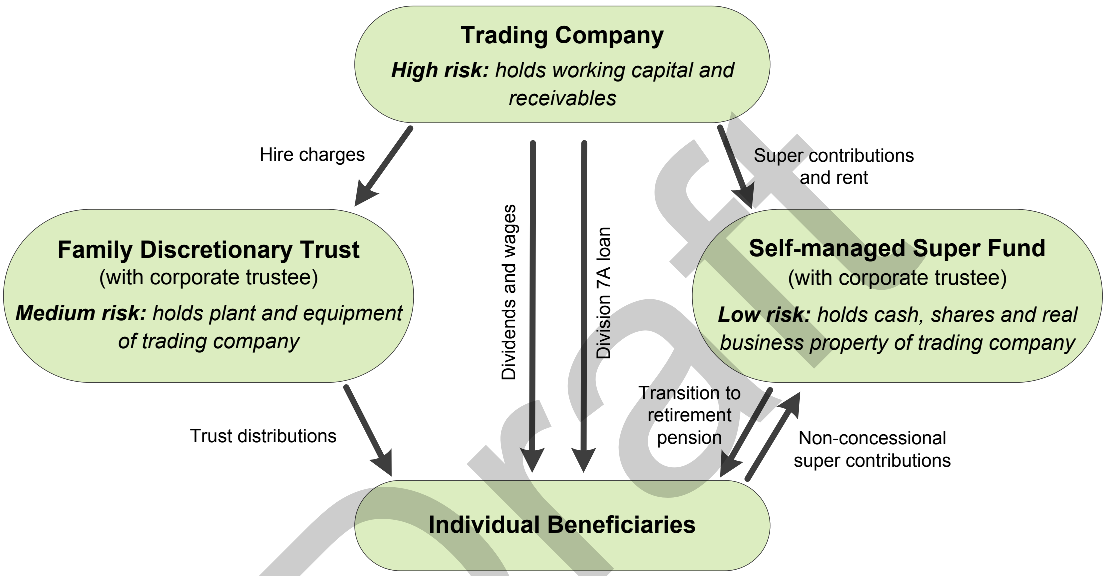
> Multiple structures are commonly needed to achieve tax outcomes which would be otherwise unavailable through a single entity …
>
> Small businesses seek measures which promote asset protection, the retention of profits for working capital, lower tax rates, access to CGT discounts, succession planning and income distribution. A combination of entities is generally used to achieve these outcomes. (sub. 32, p. 41)

There is no end to the different permutations that might occur, but as an example, a business may use a company or trust as a main trading company, lease assets from a trust and operate subsidiary companies for specific projects. Trust beneficiaries might also include both natural persons and corporate entities, known as ‘bucket companies’. Bucket companies are used as beneficiaries in order to retain trust income without paying more than the corporate rate of tax, which would be the case if the marginal tax rates of all the natural beneficiaries are above the corporate rate. Figure 4.6 provides an illustrative example of the use of multiple structures to run a business (this example also includes the additional use of a self-managed super fund).

Multi-entity structures are often used for large public companies, whereby companies will be structured with a number of subsidiary companies for specific business functions or enterprises.

Complex business structures may also be used for tax minimisation or avoidance purposes, as the use of multiple entities reduces transparency, making monitoring of compliance more difficult for regulators.

Figure 4.6 **Stylised example of a complex business structure**



Source: Adapted from The Board of Taxation (2014)

4.4 Issues and concerns with current business structures

There are some broad issues and concerns around the current business structures available in Australia. These include:

- some concerns around regulation of companies, particularly around insolvency and directors' liabilities
- the complexity and uncertainty surrounding the taxation of trusts
- distortions in the choice of business structure and the incentives to create overly complex structures.

There are a few issues around companies

There are some issues or concerns around regulation of companies, although not many have been raised in the course of this inquiry. There have also been concerns raised that, in some cases, it is too easy to set up a company and that there needs to be more stringent identification requirements for company directors. This relates to cases where companies are set up for fraudulent purposes using fictitious or incognisant directors, including for phoenix activity. These issues are discussed further in chapters 14 and 15.

Some issues surrounding the use of companies were identified by the Parliamentary Joint Committee on Corporations and Financial Services (2013), in its review on family businesses, including:

- the limit of 50 non-employee shareholders for a private company
- Division 83A employee share schemes
- creating 'associate directors' to provide additional advisors without liability.

However, these issues are only tangentially relevant as barriers to business entry, in so far as they make the choice of a company less attractive for starting a business than it might otherwise be.

Some other issues around companies include the potential expansion of no liability structures and rules around the utilisation of losses.

Expansion of 'no liability' structure for high risk start-ups?

There have been suggestions that a 'no liability' structure — currently only available to mining companies — could be extended to tech start-ups as a way of encouraging investment and reducing the stigma of failure by signalling the risky nature of these businesses. However others have suggested such a move would not be useful and that changes to the rules around insolvent trading would be a better option for increasing the appetite and acceptance of riskier business start-ups (Head 2015).

It is not clear to the Commission that the no liability structure would necessarily enable a high risk tech start-up business to attract more equity than it otherwise could. Rather, there are likely to be other more direct ways that governments could address any equity financing limitations for new businesses (these are discussed in chapter 6).

Utilisation of losses

The tax system treats losses differently to gains. While gains are taxed in the income year they are realised, losses generally have to be carried forward and offset against future income. There are also some integrity tests that must be met (such as the continuity of ownership or same business test) in order to utilise losses.

For completely new business ventures, differences in the treatment of losses between sole traders and partnerships on one hand, and companies and trusts on the other, can affect the choice of structure — if there is a likelihood of an initial loss from the business venture then the former structures may be chosen to apply those losses against other income.

However, the restrictions around the use of losses can also affect expansion and investment in new enterprises by existing businesses. If the new investment presents the possibility of causing a loss, then requirement to carry the loss forward may reduce business investment activity compared to the case where businesses are able to offset those losses against taxes already paid.

The tax treatment of losses was reviewed by the Business Tax Working Group (2012), which recommended the introduction of a loss carry back mechanism, limited to companies, that would allow losses (capped at $1 million) to be carried back and offset against the previous two years (but phased in with an initial one year carry back period.

The loss carry back mechanism was subsequently introduced by the Australian Government in 2013, but removed in 2014 as part of the repeal of the minerals resource rent tax.

Allowing loss carry back has taxation revenue implications. These are of both a temporal nature, and to the extent that losses may remain unutilised, one of quantum. But the current one year time period for determining tax liabilities is an arbitrary choice, and arguably a relatively short span of time for many business activities. Allowing loss carry back reduces that arbitrariness, while limiting the allowable carry back to a defined period, such as one or two years, reduces the risk to revenue. While the measure was repealed due to revenue implications, it has merit for encouraging investment and entrepreneurial activity and the reintroduction of such a mechanism should be reconsidered. This issue was raised in the recent tax discussion paper (The Treasury 2015b) and should be considered further as part of the White Paper on the Reform of Australia’s Tax System.

Complexity and taxation issues with trusts

There are a number of issues around the operation of trusts and their use for operating businesses. Historically, trusts have been used more for the holding of passive investments, particularly real estate, rather than the active operation of commercial activities and consequently are ill-suited in some respects to this use (in particular, the retention of profits for business expansion purposes). Trusts are inherently complex and opaque structures used to protect assets and minimise tax. To that end, there have been ongoing compliance activities to counter the misuse of trusts for tax purposes. For example, in 2013, the then Australian Government announced new funding for the ATO to target the misuse of complex tax structures by high-wealth individuals (ATO 2013b).

There have also been a series of review processes that identified the need for reform around the taxation of trusts.

The Henry review (2010) of the tax system recommended that reforms be made to taxation of trusts to reduce complexity and uncertainty around their use.

Subsequently, in 2011, the Treasury commenced a consultation process to examine reform options for modernising the taxation of trust income (The Treasury 2011). It then subsequently released an options paper on reform options (The Treasury 2012). The later paper discussed two different models for taxation — the 'trustee assessment and deduction' model and the 'proportionate within class' model. It also noted five policy principles that reforms should be consistent with:

> 1. Tax liabilities in respect of the income and gains of a trust should 'follow the money' in that they should attach to the entities that receive the economic benefits from the trust.
>
> 2. The provisions governing the taxation of trust income should be conceptually robust, so as to minimise both anomalous results and opportunities to manipulate tax liabilities.
>
> 3. The provisions governing the taxation of trust income should provide certainty and minimise compliance costs and complexity.
>
> 4. It should be clear whether amounts obtained by trustees retain their character and source when they flow through, or are assessed, to beneficiaries.
>
> 5. Trust losses should generally be trapped in trusts subject to limited special rules for their use. (The Treasury 2012, p. 7)

At the time, the then Australian Government ruled out the reform option of taxing trusts like companies (The Treasury 2012). Further, there does not appear to have been any progress beyond the release of the 2012 options paper.

The 2013 Joint Committee Review on Family Businesses in Australia identified a number of key concerns, including around tax issues, that were raised around the operation of businesses through trusts (box 4.1).

Box 4.1 **Issues with trusts identified by the 2013 Joint Committee Review on Family Businesses in Australia**

This review identified a number of key concerns or issues with the operation of trusts.

- Division 7A — (provisions to prevent access to company funds, such as through loans, without funds being properly distributed and included in personal tax) deferred to Tax Board inquiry (see box 4.2 for more details).
- Division 6 — issues about how tax is applied where income is retained in trust (issue of retaining working capital for business purposes).
- Capital gains tax (CGT) rules — concerns that CGT rules erode business assets and potentially affect viability in succession process. There were changes that made trust cloning more difficult. The issue is that there are ways to work around, minimise, or delay CGT liabilities, which create some inefficiencies.
- Property settlement rules — concerns that trusts are not fully protected from family law property settlements and discretionary trusts can be subject to family law settlements — the Committee saw sound reasons for this.
- Rule against perpetuities — trusts cannot operate in perpetuity. This is intended to prevent dead people from tying up assets indefinitely, but there is evidence that in cases of trusts being used for running businesses, it creates additional uncertainty and limits growth. It also creates additional restructuring costs. It was recommended that COAG inquire into the abolition of this rule (it has already been abolished in South Australia).

Source: Parliamentary Joint Committee on Corporations and Financial Services (2013)

Perhaps the most significant concern is the operation of Division 7A of Part III of the *Income Tax Assessment Act 1936*, which is considered to be overly complex and burdensome. The operation of Division 7A has been recently reviewed by the Board of Taxation, but the report has not yet been released by the Australian Government. A key issue with respect to Division 7A is the use of a corporate beneficiary as a means for retaining income for business purposes within the trust (box 4.2).

Another potential issue with trusts is that they are subject to state laws and there is therefore scope for considerable variation in trust law across Australia. For example, the Victorian Law Reform Commission (2015) has just released a report recommending changes to the *Trustee Act 1958* (Vic) to give new rights to the beneficiaries of trading trusts. Variation in laws governing trusts could potentially create issues for businesses that operate in multiple jurisdictions, although no evidence has been presented to the Commission in the course of this inquiry to suggest this is a major issue for business set-up or closure.

Box 4.2 Division 7A issues – trusts and corporate beneficiaries

Division 7A was introduced in 1998 to prevent private companies from making tax-free distributions of profits to shareholders or associates in the form of payments or loans.

The gap between the corporate tax rate and higher personal marginal tax rates creates an incentive to accumulate funds within a private company, rather than distribute it to shareholders.

Because trusts are taxed on a flow-through basis, a common practice is for trusts to include a corporate beneficiary (known as a bucket company), with income received by the company subject to tax at the 30 per cent corporate rate. Further, these distributions to corporate beneficiaries are often not fully paid and retained within the trust for business or investment purposes. These unpaid distributions are referred to as unpaid present entitlements (UPEs).

There are significant complexities where trusts retain funds (UPEs) that are nominally distributed to company beneficiaries to use as working capital. Either, steps need to be taken to avoid the application of Division 7A (such as holding funds in a sub-trust, and making a loan to the main trust on commercial terms), or the UPE must be structured as a complying loan (these are inflexible and require annual payments of principal and interest over specified terms).

The Board's discussion paper canvassed an option of simplifying the retention of funds, taxed at the corporate rate, for working capital. They also proposed that if a trust made this election they would be ineligible for the 50 per cent CGT discount, as per companies.

Source: The Board of Taxation (2014)

Submissions to this inquiry have also raised taxation concerns around the use of trusts. CPA Australia, echoing its earlier submissions to the Treasury on modernising the taxation of trusts, submitted that:

> Consideration be given to replacing the current taxation of trust regime with a regime which:
>
> - recognises taxable income derived by fixed trusts be taxed on an attribution basis
> - non-fixed trusts carrying on investment activities be treated as a flow through vehicle with beneficiaries assessed on a 'follow the money' principle
> - non-fixed trusts carrying on a business activity be given the option to be taxed as a company at the corporate tax rate thereby allowing the trustee to accumulate after-tax profits (sub. 30, p. 4)

CPA Australia also noted that allowing non-fixed (discretionary) trusts to be treated as a company would:

> … allow such business trusts to re-invest their after-tax profits into working capital thereby obviating the need for such trusts to make unpaid distributions to private company beneficiaries and the related Division 7A complexities. (sub. 30, p. 4)

Under their proposal, trusts making such an election would also lose the ability to claim the 50 per cent CGT discount.

Trusts are complex structures, inherently unsuited to use for active business purposes, although they do have some tax and asset protection advantages. Anecdotally, the

Commission has heard that the use of trusts is often not well understood by business owners using them. The Commission was also told that in many cases, they are an unnecessary level of additional complexity foisted on business owners by professional advisors locking owners into an ongoing need for more complex and expensive professional services.

Reform of the treatment of trusts, including taxation, should be considered within the context of the taxation of business more broadly, including the scope for removing distortions.

Removing distortions between business structures

The current taxation regime creates considerable discrepancies in the way businesses are taxed, depending on the business structures they adopt. This means that business and investment decisions may potentially be made on the basis of tax-treatment, rather than economic merit. And, to the extent that business structures are being used to minimise tax, some businesses are benefiting from an effective subsidy through the taxation system. This results in inconsistent treatment of businesses, erosion of the income tax base, a potential bias in investment towards activities that generate low pre-tax returns and a distortion in the allocation of resources across the economy.

These issues raise the question of whether there should be harmonisation of business taxation across structures. Typically, responses to this issue have focused on changing the taxation of trading trusts to be more like companies, essentially by allowing income retained in trusts to be taxed at the corporate rate. This would potentially address the Division 7A issues and make it unnecessary to use bucket company beneficiaries. However, a similar outcome could also be achieved by operating a business through a company. Trust benefits (around discretionary distributions) could then be accessed if the company was owned by a trust. In this sense, trusts could be restricted to use as more passive investment vehicles.

Aside from the difference in the tax treatment of companies and trusts, a similar difference exists with respect to sole traders and partnerships. Similar to using trusts, albeit without the flexibility of varying distributions, sole traders and partners are taxed at their marginal personal tax rates. This potentially creates a distortion compared to companies, where earnings are retained for business purposes (unless a partner or sole trader's marginal tax rate happens to be equivalent to the flat corporate rate). One potential solution to this distortion is the introduction of a new entity, readily accessible to new small to medium businesses that would allow for accumulation for business purposes at the corporate tax rate. Such an entity would be along the lines of the 'S corp' entity used in the United States. CPA Australia submitted that:

> … there may be merit in exploring the concept of introducing a US 'S corp' style entity as a vehicle through which a small to medium sized enterprise (SME) can carry on a business in Australia. (sub. 30, p. 4)

While also acknowledging that:

> This potential reform has been raised on a number of occasions. We acknowledge that like all major reform options it is not without its issues including its application in tax laws, corporations law, insolvency law and other business law.
>
> Notwithstanding these comments, we believe that the concept of an additional entity being made available for Australian businesses with features of income streaming, income retention and limited liability should be considered as part of the proposed forthcoming Tax White Paper tax reform process. (sub. 30, p. 4)

Such a structure would potentially lead to greater consistency in the taxation of businesses, regardless of structures, but there are also likely to be broader taxation issues to consider. The attraction of accumulating funds in corporate structures has increased as corporate tax rates have been progressively lowered. Reduction of corporate tax rates has been done on the basis of reducing barriers to the attraction of foreign capital. Extending these benefits to what are currently sole traders or partners taxed on the personal income tax rates would reduce the progressiveness of the income tax system, and introduce additional tax distortions between business owners and other tax payers, such as wage and salary earners.

The distortions and complexity of the tax system, particularly for small businesses, have already been noted in the initial discussion paper released in March as part of the White Paper process. In particular, the paper notes that:

> Navigating a complex tax system can be disproportionately burdensome for small businesses, especially where certain features of the system encourage them to adopt particular legal structures that are costly to establish and maintain. … [and]
>
> The different treatment of different legal entities, and the ability of a small business owner to navigate this complexity, can have a significant effect on a business' tax liability, and can lead to different tax outcomes for economically similar activities. (The Treasury 2015b, pp. 105, 108)

In the Commission's view, the taxation of businesses, and the distortions created by the differing tax regimes, should be fully examined as part of the White Paper on the Reform of Australia's Tax System.

DRAFT RECOMMENDATION 4.1

In principle, there should be a consistent approach to the taxation of business entities regardless of their ownership structure and size. The White Paper on the Reform of Australia's Tax System should consider in particular:

- the taxation of trusts used primarily for business purposes
- the tax treatment of profits and losses and the feasibility of a simpler entity for small business that would combine features of existing structures.

5 Access to finance for new businesses

Key Points

- Many new businesses do not require financing that is external to the resources of the business owners.
- A range of studies undertaken over the last five years have consistently concluded that while some businesses do experience difficulty accessing finance, the problem is not widespread. This has been supported by the Commission's consultations with the finance sector and business organisations.
  - Innovation active businesses are more likely to identify access to finance as a barrier, although their ability to access finance is similar to non-innovative businesses.
  - The Commission has found little evidence to suggest that access to finance is a barrier to new large businesses, such as those formed from privatisations or large corporate restructurings.
- There is an array of financing sources available to new businesses including the personal finances of business owners, venture capital, bank loans, government grants, peer to peer lending and crowd-sourced equity finance.
  - Of these, personal finance is the dominant source of finance for new businesses, reflecting the fact that the bulk of new businesses begin as micro or small entities.
- Several factors determine the financing mix of new businesses including the cost, availability and complexity of different finance types and the amount of finance needed.
- New businesses face considerable financial uncertainties, for example, around future costs and revenue streams, market appetite for new products and services, the regulatory environment and/or the viability of unproven business models. Lack of information about these risks and a deficiency of assets to use as collateral can make it more difficult to secure adequate financing at an acceptable cost for some new businesses.

For many, setting up a new business requires finance — inventory or inputs must be purchased, premises leased and staff employed. While some new businesses may be financed exclusively through the personal savings of the proprietor, many require capital from other sources. For others, such as a consultancy business with a single professional employee, little or no financing is required.

It is inevitable that for some new businesses, accessing finance is difficult. By their nature, new businesses are unproven — and some proposals are unviable or unsustainable. New businesses may also seek finance without a fully developed and creditable business plan, and given this may — perfectly reasonably — be denied.

Accepting this fact, in examining the ability of new businesses to access finance, the Commission has sought evidence of widespread or systematic difficulties or issues, including for particular types of new businesses, or for particular types of financing.

The extent that access to finance, or particular kinds of financing, presents a barrier to new businesses is explored in this and the subsequent two chapters. This chapter examines the types of finance available to new businesses and the broad barriers they face when attempting to access finance. Chapters 6 and 7 discusses specific issues relating to equity and debt financing respectively.

5.1 Is there evidence that access to finance is an issue?

Participants raised access to finance as an issue …

A number of submissions indicated that access to finance represents a barrier to setting up a business. For example, the Australian Small Business Commissioner commented that:

> … obtaining finance to establish or grow is critical and generally the finance sector in Australia is able to manage with minimal Government intervention. However, with the exit of some non-bank financing streams (such as finance companies) as a result of the Global Financial Crisis, as well as immature alternative financing options compared to other countries (such as venture capital and crowdfunding), access to finance still rates as a concern for many small businesses. (sub. 10, p. 8)

The Chamber of Commerce and Industry Queensland presented similar concerns:

> Access to finance is a significant issue for all small businesses looking to invest and grow. Stricter lending requirements post-GFC has limited avenues for small business to access finance for working capital, investment and business expansion. (sub. 8, p. 6)

Further, Restaurant and Catering Australia submitted:

> Businesses in the restaurant, café and catering sector have significant issues access finance at a reasonable cost. (sub. 21, p. 11)

Such concerns have also been a feature of past reviews. For example in its submission to the recent Financial System Inquiry, the Association of Mining and Exploration Companies (AMEC 2014) stated:

> As access to capital is a major problem for start up/junior mineral exploration companies and emerging mid tier miners, AMEC considers there is an opportunity for an increased role for the banking sector to stimulate venture capital (p. 4)

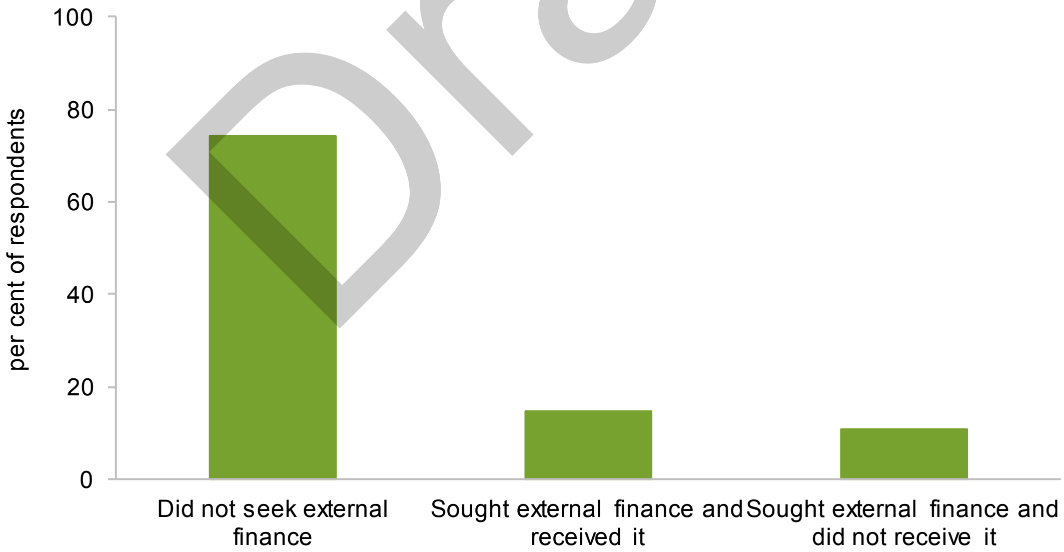
While the NSW Government (2014b) submitted to the same inquiry:

> For Australian small businesses, access to finance is the number one barrier to innovation and the third largest barrier to general business activity. Approximately 10 per cent of all Australian small businesses have difficulties accessing finance.
>
> … Small businesses and start-ups have specific needs, requirements, issues and risk profiles compared to larger businesses (p. 8)

… but broader evidence suggests problems are not widespread

There are relatively few studies that focus on the extent to which access to finance represents a specific barrier to new businesses in Australia. A study by Davidsson, Gordon and Steffens (2012) found that around three-quarters of nascent businesses do not seek ‘external’ financing for the business itself (figure 5.1).[7] However, this does not include personal forms of finance (for example personal credit cards or loans against housing equity) that many business owners use to start a business.

Figure 5.1 **Nascent businesses seeking external finance, 2007-2011**
Includes both debt and equity



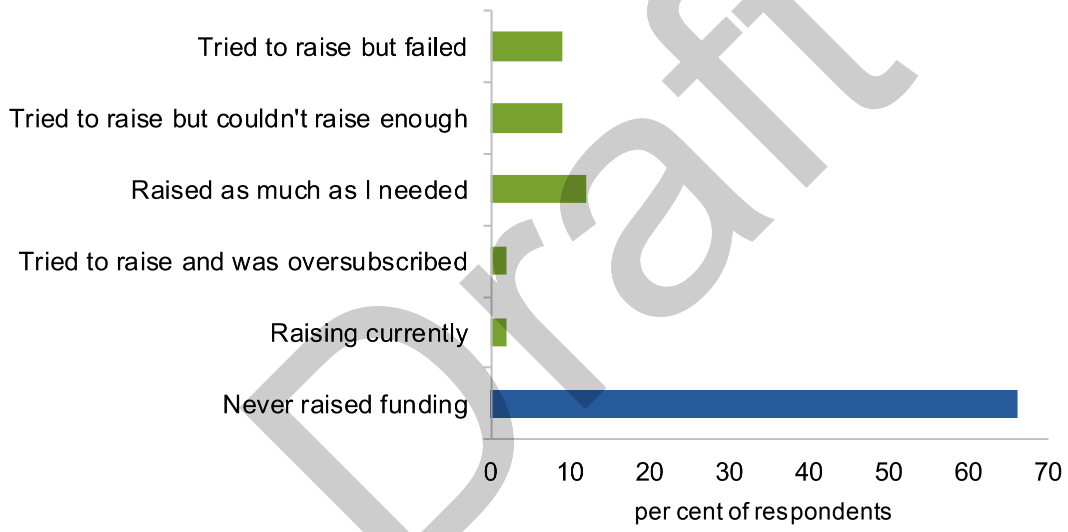
Source: Davidsson, Gordon and Steffens (2012)

[7] Davidsson, Gordon and Steffens (2012) define a nascent business as ‘firms in the processes of being created, but not yet established in the market’.

Only about 10 per cent of nascent businesses sought external financing and did not receive it. This suggests that while some new businesses undoubtedly face problems in accessing finance, these are not necessarily widespread. Discussions that the Commission has had with a range of stakeholders during the course of this inquiry suggests that in many of the cases where finance could not be obtained, the organisation lacked a viable business case or was unable to demonstrate it to a reasonable level of detail.

Results from the 2014 survey into business start-ups undertaken by *Startup Muster* present similar findings. It found that most new businesses (66 per cent) have not tried to raise finance. Only 9 per cent of start-ups sought but failed to raise finance, while an additional 9 per cent sought financing but could not raise enough (figure 5.2).

Figure 5.2 **New business's experiences raising finance, 2014**



Source: Startup Muster (2014)

Studies that examine the overall ability of small and medium businesses to access finance are more common, and given that the vast majority of new businesses begin as small businesses, these studies can also provide broad but useful indications about how common difficulty accessing finance may be for new businesses.

- A report prepared by Deloitte Access Economics for the NSW Business Chamber identified that around 10 per cent of small and medium businesses experience difficulty accessing capital. Their study also found that newer businesses (those aged between one and three years) were more likely to be refused finance than older businesses (Deloitte Access Economics 2013a).
- Holmes and Gupta (2015a) presented that overall, access to finance was not a high priority issue for small Australian businesses, with concerns rating as higher importance including maintaining and growing revenue, economic uncertainty,

competition and red tape, taxation and compliance. However, difficulty accessing finance is more pronounced for some businesses than others. For example, for businesses the authors categorise as 'financially constrained growth aspirers' access to finance was reported to be much more of a concern than for the wider small business population.[8]

- Research undertaken by the Australian Bankers' Association and the Council of Small Business Australia estimated that around 11 per cent of small businesses state that 'access to finance or the capacity to finance further growth in the business is an issue' (p. 7). Only about 5 per cent of small businesses identified access to finance as a major concern. Concerns that ranked higher included the economic environment, costs, government regulation, finding staff, interest rates and the value of the Australian dollar. That said, this figure doubles to around 10 per cent if only high growth small businesses are examined (ABA and COSBOA 2013).
- In their submission to this inquiry, CPA Australia (sub. 30) quoted results from their 2014 small business survey that found that half of respondents found that accessing finance was easy or very easy, with only roughly a quarter indicating it was difficult or very difficult. The survey also found that 'the 12 months to September 2014 was the easiest period for Australian small business to access finance since the survey began in 2009.' (p. 9). Likewise, in their submission, the Institute of Public Accountants (sub. 32) noted that:

  On average, between only 7 and 8 per cent of businesses seeking external finance are unable to secure funding from external markets. This is 'typical' for developed economies in periods of economic growth (p. 11)
- The interim report for the *Financial System Inquiry* (the Murray Review) found the majority of SMEs did not experience difficulty accessing external debt finance with approval rates above 80 per cent since 2006-07. That said, the review also acknowledged that the approval rates for new businesses are 'much lower' (The Treasury 2014c, p. 2-60). The report also noted that 'banks' business models and expertise are more suited to providing debt finance to established businesses, whereas venture capital is more suited to start-up businesses in nascent industries'. (p. 2–59)

Broadly speaking, these studies suggest more favourable investment conditions for SME than studies undertaken in the immediate aftermath of the Global Financial Crisis (box 5.1).

8 The study states that that 'financially constrained growth aspirers' are 'younger businesses mostly seeking growth but are struggling to achieve it.' (p. 8). The study states that most businesses who fall into this category are small (90 per cent have a turnover of less than $500 000 and less than four employees) and relatively young (44 per cent have been in operation for more than three years).

Box 5.1 **Selected studies into the effects of the GFC on SME finance**

The Global Financial Crisis (or GFC) is typically regarded as beginning in mid 2007. The end point of the GFC is more debated although the National Bureau of Economic Research in the US states that the recession associated with the GFC ended in mid-2009. The effects of the GFC varied between countries, and it is accepted that Australia fared better than most other developed nations.

Nevertheless, the GFC did have an adverse impact on access to finance for Australian businesses. The effects of the GFC on SME finance were examined in two Parliamentary inquiries.

- A Senate Inquiry into *Access of Small Business to Finance* undertaken in June 2010 noted a marked slowdown in the lending of credit to small businesses, which is attributed to both supply factors (including fewer loanable funds and tighter lending standards post GFC) and demand factors (including a lack of need or desire from businesses to undertake new debt).
- A Parliamentary Joint Committee Inquiry undertaken in April 2011 also attributes a reduction in the amount of business lending undertaken during the GFC to supply and demand factors. The inquiry noted that SME lending was less affected than lending to large businesses, however, the cost of accessing finance was clearly higher as a consequence of the GFC.

Source: Parliamentary Joint Committee on Corporations and Financial Services (2011); The Senate Economic Reference Committee (2010)

International benchmarking studies can also provide broad indicators of the capacity of businesses to raise finance in Australia. One study by the World Bank Group (2015b) ranks Australia fourth out of 185 jurisdictions for ease of getting credit. Another study undertaken by the World Economic Forum (2012) finds that Australia is above average on most financial access indicators including financial market sophistication (ranked 9 out of 62), ease of financing through local equity markets (ranked 10) and ease of access to loans for organisations with a good business plan with no collateral (ranked 17). On access to venture capital, Australia rated lower (ranked 21).

In summary, the majority of evidence suggests that only a small minority of new businesses experience problems accessing finance. For most businesses, access to finance does not represent an impediment or barrier to setting up.

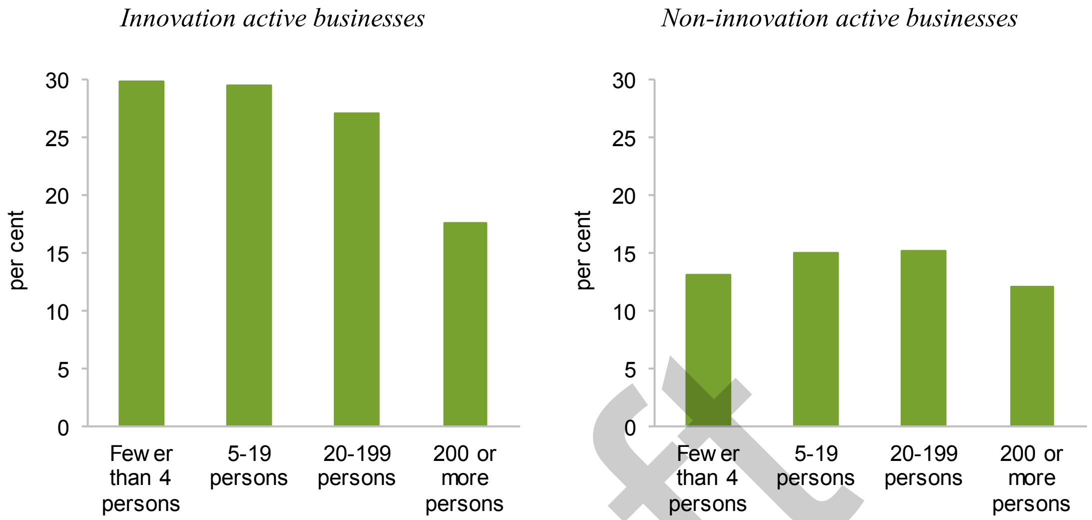
Is the story different for innovative businesses?

It is difficult to be conclusive on the extent that innovative businesses find it more difficult to access finance compared to more conventional new businesses.

Smaller, innovation active businesses are more likely to report that access to additional funds is a barrier to innovation than both larger, innovation active businesses and non-innovation active businesses (figure 5.3).

Figure 5.3 **Businesses that identified lack of access to additional funds as a barrier to innovation**[a]

By innovation status and number of employees (2012-13)



[a] Does not include non-employing businesses. The ABS definition of innovation is 'the introduction of a new or significantly improved good or service, operational process, organisation/managerial process or marketing method'. In addition, a business is considered to be innovation active if it introduced an innovation that was new to the world, new to Australia, new to the industry or new to the business. This differs from the definition of 'truly innovative' businesses the Commission has used in chapter 2 which excludes innovations that are new to the industry or new to the business from its analysis.

Source: ABS (2014e)

There is also evidence to suggest that high growth potential new businesses have a much greater need for external finance than the general new business population. CAUSEE data indicates over 60 per cent of high potential businesses seek finance compared to just 25 per cent of 'regular' businesses. However, the data shows that:

> The success rate in receiving external funding is similar for each type of firm, at just under 60 per cent. This shows that while [high potential] firms have an increased need for external funding, the nature of their firm does not convey an increased ability to secure it. Taken at face value this result suggests that [high potential] firms are not treated as special cases by external financiers. (Gordon and Davidsson 2013, p. 6)

Although the success rate of accessing finance for high potential and regular businesses is the same, there is some difference where these businesses source their finance — most notably, high potential nascent businesses are much more likely to use government grants as a major source of finance than the general start-up population, and are less likely to utilise bank debt products (Gordon and Davidsson 2013).

5.2 Types and sources of business finance

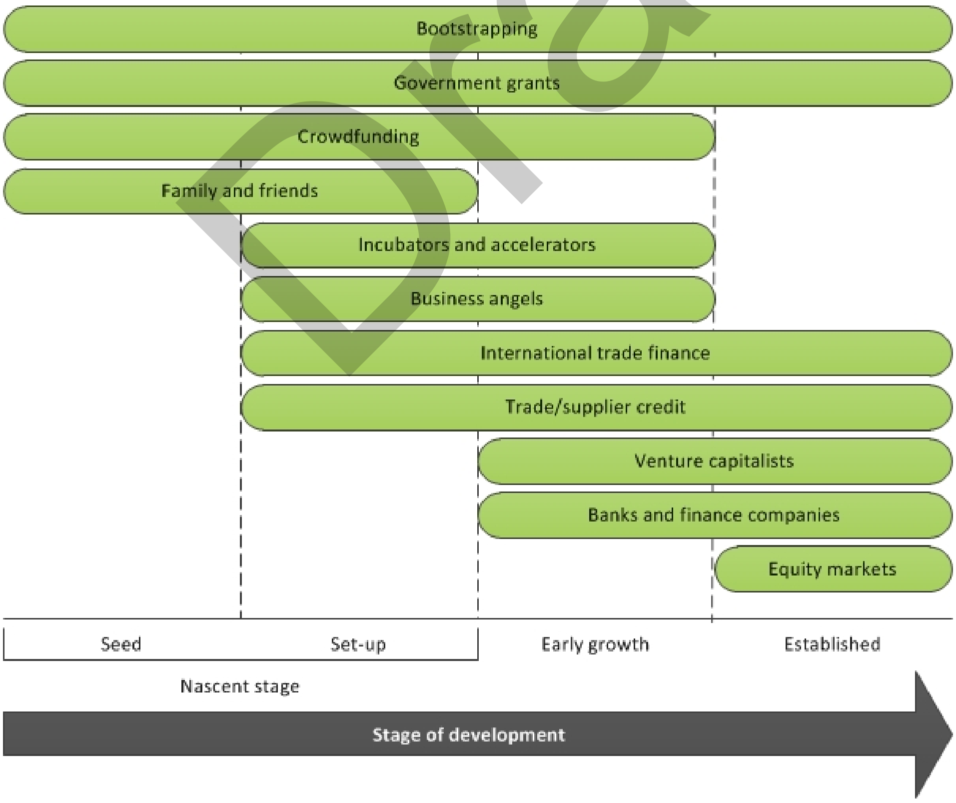
Most business finance can be classified as equity or debt finance.

Equity finance involves a business receiving finance in exchange for a share of ownership. Equity financing gives the investor a claim to part of the returns of being in business (usually through a share of the profit, dividends or capital growth) and potentially a degree of control over the business. The share of returns and degree of control enjoyed by an investor is typically dependent on the amount of equity invested in the business.

In contrast, debt finance involves a business receiving finance in the form of a loan from another organisation or individual. Unlike equity, there is no exchange of ownership — investors receive repayment of the loan and any interest owed, and their claims typically rank before those of equity providers in the event of a business being wound up.

Finance for new businesses comes from a variety of sources, and different forms of finance typically open up to businesses at different stages of business development (figure 5.4).

Figure 5.4 **Sources of business finance**



Source: Adapted from Van Osnabrugge and Robinson (2000, p. 37)

Most new businesses are founded — at least in part — through what is known as 'bootstrapping'. This involves a business owner drawing on their existing financial resources to establish their business — including personal savings, personal credit cards and/or equity in personal assets such as real estate. This can be complemented with debt or equity finance from family and friends.

Another potential source of finance for new businesses is government grants, loans and guarantees. The Australian and state and territory governments provide financial assistance to selected new businesses, much of which is targeted to supporting new and innovative businesses. Government assistance to businesses is discussed in chapter 11.

Crowd-sourced funding is a source of finance for new businesses that has become increasingly accessible through use of the internet. Under crowd-sourced funding, business owners seek relatively small contributions from a large number of investors in order to obtain finance for their business or facilitate the commercialisation of a new product. Crowd-sourced funding is usually facilitated through an online platform — for example Kickstarter, Quirky or Indiegogo — and takes four main forms:

- *Donation crowd-sourced funding* occurs when money is donated towards a project, but no reward is given in return.
- *Reward crowd-sourced funding* occurs when a backer obtains some reward in return for their contribution. Examples may include an opportunity to pre-order the backed product, merchandise or voting on its design. In many cases, this type of crowd-sourced funding is nothing more than prepayment for goods and services, albeit digitally enabled (box 5.2).
- *Debt crowd-sourced funding* operates in a similar manner to other forms of debt financing. Contributors loan money to the business, that then repays loans with interest at a later date. Peer to peer lending, discussed in chapter 7, represents a form of debt crowd-sourced funding.
- *Equity crowd-sourced funding* involves backers receiving equity in the organisation in exchange for their contribution. The backer may then receive a return on their equity, either in the form of dividends or capital growth (Masscatalyst 2015). Equity crowd-sourced funding is explored in chapter 6.

Beyond restrictions to equity crowd-sourced funding — explored in the next chapter — the Commission has not been informed of any substantial barriers inhibiting crowd-sourced funding in Australia. The Commission considers this as prima facie evidence that current arrangements work well. Nevertheless, the Commission values further feedback from stakeholders, including around what protections should be afforded to participants who use crowd-sourced funding.

Box 5.2 Some recent examples of crowd-sourced funding by Australian businesses

- ***The Flow Beehive*** is a new beehive design where honey can be extracted without disturbing the hive. It was invented by a father and son team near Lismore, NSW. The inventors listed the Flow Beehive on Indiegogo where they received $US12m of support from over 36 000 people in its first month. People who supported the beehive were given the opportunity to pre-order the product, or other 'perks' such as postcards and beekeeper suits.
- ***Satellite Reign*** is a personal computer game by a new Brisbane based independent games development company. The game was listed on UK Kickstarter, and received £461 000 from around 15 000 backers. Depending on the amount invested, backers received exclusive content, characters in the game named after them or listing in the credits of the game.
- ***Micro-phone*** is a mobile phone device about the size of a credit card and weighing fewer than 40 grams with and can including tracking and locating customisations. In three months, it raised over $US180 000 from over 2600 backers. Backers could pre-order the product or extra features.

Source: Fitzsimmons (2014)

INFORMATION REQUEST

What impediments (apart from those specific to the Corporations Act 2001 (Cth) for crowd-sourced equity funding) are there to the use of crowd-sourced funding in Australia? What protections should be afforded to investors, consumers and businesses that use crowd-sourced funding platforms?

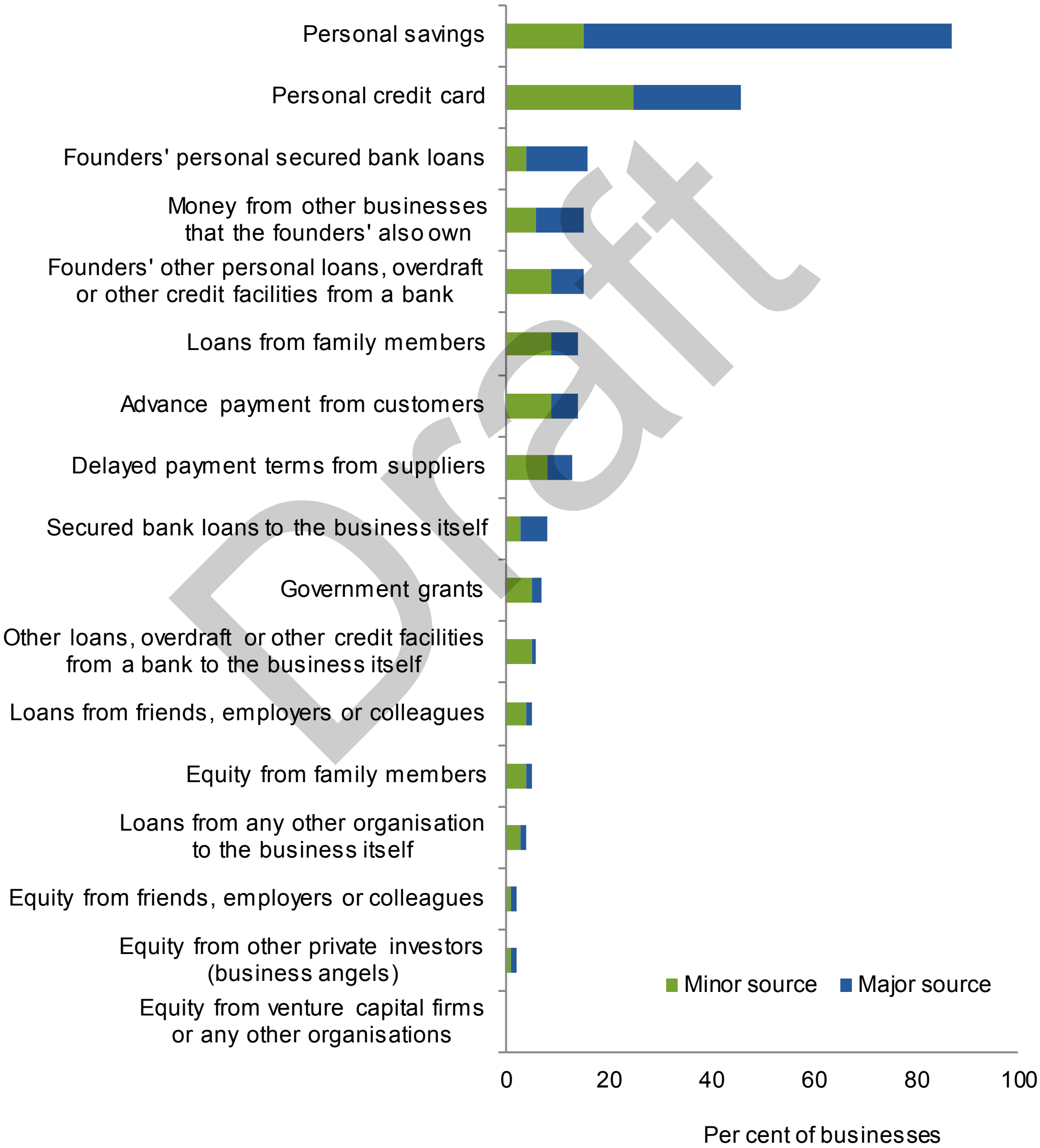
For new businesses with an export or import focus, international trade finance represents an important source of finance. Trade finance refers to a range of products — either government or private sector provided — such as loans, bonds or guarantees designed to partially mitigate the risks associated with cross-border trade. The Commission explored trade credit in detail in its recent inquiry into Australia's export credit arrangements (PC 2012c).

Some forms of equity finance, such as business angels or venture capital, may be available to some businesses in the early stage of their life. Another source of equity financing for new businesses are employee share schemes, These forms of equity financing are explored in chapter 6.

Loans may be available to new businesses, although typically appropriate collateral (either residential or commercial assets) and a proven and secure revenue base is a prerequisite. Arguably, more relevant for new businesses is trade credit, where suppliers allow businesses to delay payment for goods and services received. Debt financing is explored in chapter 7.

The relative importance of these financing options for nascent businesses in Australia has been explored by Davidsson, Gordon and Steffens (2012). By far, nascent businesses rely most on personal forms of finance — including savings, credit cards and personal bank loans — to finance their start-up. The dominance of these methods of finance highlights how the distinction between personal and business finance is often blurred (at least, for micro and small businesses) during the early stages of a business start-up (figure 5.5).

Figure 5.5 **Sources of finance for nascent businesses, 2007[a,b]**



[a] Based on a sample of 625 nascent businesses. [b] A 'major source' of funding is defined as representing at least 20 per cent of total funding needs.

Source: Davidsson, Gordon and Steffens (2012)

Unfortunately, more recent (post GFC) data specific to new businesses is not available. However, analysis undertaken by Matic, Gorajeck and Stewart (2012) for the RBA Small Business Roundtable notes that 'internal equity funding and existing debt facilities meet small business' needs', and when intermediated debt is used, this is most likely to be a credit card or secured bank loan. This broadly matches the findings of the ABA that indicate that credit cards, overdrafts and long term loans are the most common lending products used by small businesses. While these findings relate to established businesses, it does nevertheless overlap with the findings of Davidsson, Gordon and Steffens with respect to new businesses.

Startup Muster's 2014 survey of business start-ups also revealed the dominance of private forms of capital for financing new businesses. It found that private capital from Australia was used to finance 61 per cent of start-ups while 10 per cent of start-ups utilised capital from overseas. In contrast, bank loans were used in only 2 per cent of cases, while crowd-sourced funding and ASX listing were used in only 1 per cent of start-ups (StartupMuster 2014).

What factors determine the financing mix?

Some new businesses are founded using only one type of finance — for example, the personal savings of the business owner. Other new businesses utilise finance from an array of different sources. The financing mix a business uses is determined by a range of factors.

The amount and nature of finance needed

The amount of financing needed to start a business can influence the sources of financing sought. Smaller investments can more readily be met through personal sources or from friends or family, while larger investments may require external finance and/or multiple sources of finance.

The StartupMuster survey (2014) provides insight into the quantum of finance used to establish new businesses. 37 per cent of new business have total finance of $50 000 or less and 71 per cent have total finance below $250 000. These relatively low thresholds may indicate why many businesses are able to be established solely with personal finance (including mortgages). At the other end of the spectrum, roughly 13 per cent of new businesses had total financing of $1 million or more.

The timeframe that new businesses require finance can also influence the finance mix. A short term need for finance — potentially for liquidity reasons — can be serviced through a credit card or loan from family or friends. A long term need for finance — such as to purchase a critical asset — might best be met with a form of finance with a longer payback horizon, such as a business loan.

The cost and availability of different forms of finance

All forms of finance have a cost associated with their use. Loans must be repaid over a defined period with interest. Business angels and venture capitalists are paid based on future earnings. Personal savings invested in a business have an opportunity cost associated with them as they could be used for consumption or alternative investments. These costs — on a relative and absolute level — as well as relative availability influence how much finance new businesses seek from which sources. Cost and availability are in turn a function of the nature of the business and the degree of risk or uncertainty associated with it. In addition, some forms of financing, for example, equity financing through an ASX listing, are only available to businesses of a certain size.

Degree of risk and uncertainty

New businesses carry significant uncertainties for investors. The business and its managers may have an unproven track record, it may involve new business models and markets and the revenue and cost bases are uncertain. The adoption of new business models challenge existing market structures and processes, and this can also pose significant regulatory risks for the business.

Businesses that are exposed to greater uncertainty may find it more difficult to access certain forms of finance, particularly if a lack of information makes it difficult for investors to understand and quantify the risks involved. For example, banks are relatively risk averse in their investment decisions, while other sources of finance — such as venture capital — are often willing to carry more uncertainty and risk in exchange for higher expected returns.

The complexity of different forms of finance

Some forms of finance are more complex than others. Obtaining finance through bootstrapping and from family and friends is relatively straightforward and usually does not involve formal, legal processes. Other forms of finance involve more complex arrangements. Investments from business angels or venture capitalists for example, involve transfers of equity in the business and can entitle the investor(s) to a significant degree of influence in the business, including through appointments on the business's management board. Listing on an equity exchange involves not only the costs associated with the initial listing and capital raising, but also ongoing reporting and governance requirements, such as meeting continuous disclosure obligations.

5.3 Why might new businesses find it difficult to access finance?

Should an investor view a new business as sufficiently risky, the size of the investment they are willing to make in the business may be reduced and/or cost of finance they are willing to provide may be increased. In instances where the investor deems the new business to be an unacceptable risk or the costs of monitoring the performance of the investment are considered high, finance is typically refused.

Compared to established businesses, new businesses are usually more uncertain or risky investments. There are a number of reasons for this:

New businesses often have little equity or assets

Where businesses do not have assets to pledge as security for a loan or business owners do not retain significant equity in a business, investors may quite reasonably require a higher return on their investment in order to carry a disproportionate share of risk relative to the business owner. If a business owner has a sizeable personal equity stake in their business, it provides a signal of confidence in the business's prospects and places an incentive on business owners to ensure their investment is well managed.

Many businesses in their infancy do not own assets of sufficient value to use as collateral for a loan, and hence find it difficult to secure debt finance. This is why some business owners turn to personal assets — typically home equity — as a source of collateral for debt finance.

The amount of information available to financers about new businesses is limited

Unlike established businesses, new businesses do not have published financial records, and usually do not have extended credit histories. New businesses have not had the time to develop a reputation and information available to investors about the management of the business, its potential market size or the quality of the business's product is typically limited.

The absence of such information makes it more difficult for potential investors to judge the magnitude of uncertainty and returns from investing in a business. One response to this lack of information is the adoption of simplified decision rules that 'may be accurate on average, but may lead to the rejection of some commercially viable transactions'. (PC 2012c, p. 157). Another response is to increase the price of finance to compensate for this additional uncertainty.

New businesses do not have established markets or revenue streams

New businesses by their nature are often founded on unproven business models. It takes time for new businesses to obtain customers, develop markets and generate revenue. Often, finance is sought before the revenue base of the new business is regular and fully secure.

A business with unproven, limited or volatile revenue streams is unlikely to be viewed as an attractive investment by either debt or equity financers. Furthermore, a lack of developed markets makes new businesses more susceptible to the volatilities of the business cycle — something that further diminishes their attractiveness as an investment.

New businesses often feature centralised governance structures

Many new businesses are started by an individual or family who exercise absolute control over the organisation. This raises 'key person' risks — how sustainable is the business if the key person is incapacitated; are there enough checks and balances in place? In addition, some investors may be concerned about the ability of these governance structures to cope with growth and expansion.

Do large new businesses face these challenges?

While most new businesses start out as small businesses, this is not always the case. For example, a new business may be established when a government asset is privatised, or when a large corporation is restructured in a way that individual parts become an autonomous business.

For large new businesses, the aforementioned challenges are much less pronounced. Usually, these organisations have proven business models, an established market and assets from previous operations. They also possess sophisticated governance structures. As a consequence, typically, large new businesses find it less difficult to source finance than a smaller new business. This is reflected in ABS data that indicates that large businesses are more likely to seek debt or equity finance and more likely to obtain it than smaller businesses. Submissions to this inquiry did not suggest the presence of substantial barriers around accessing finance for large new businesses.

The Commission examined issues relating to the financing of infrastructure, including new greenfield infrastructure, in its recent inquiry into *Public Infrastructure* (PC 2014d). This inquiry found no major impediments to securing finance, noting that:

> The finance community has generally indicated that it is only too willing to provide and finance public infrastructure projects where it has assessed the projects to be commercially viable. (p. 16)

5.4 What conclusions can be drawn on access to finance?

Given the nature of new businesses — which are often founded using unproven business models, with limited assets and by owners with limited business experience — there will always be a proportion of new businesses that find it difficult to access finance.

Indeed, that such businesses are not successful in obtaining external finance does not suggest that there are problems with the finance system, but rather that investors are engaging in a rational consideration of the risks, costs and benefits involved with financing each new business. If all new businesses were successful in obtaining external finance, this would provide an indication that investors were not taking into full consideration the uncertainties associated with financing new businesses.

DRAFT FINDING 5.1

Access to finance does not represent a barrier for most new businesses. Only a minority of new businesses seek finances beyond the financial resources of the owners, and most that do seek external finance obtain it.

Evidence that innovative businesses face additional barriers when seeking to access finance remains mixed. Innovative businesses and in particular, small innovative businesses, are more likely to identify a lack of access to finance as a barrier to innovation than large innovative businesses or businesses not undertaking innovation. However, high growth potential businesses are as likely to receive external finance as a non-high growth business. On balance, it seems likely that — similar to non-innovative businesses — while most innovative businesses do not experience difficulty accessing finance, some do. Similar to conventional businesses, this could be due to an array of reasons — for example, the business plan may be inadequate or unviable, or investors may view the risks to be too great — and itself is not evidence that there is widespread market failures.

On balance, there is not sufficient evidence to suggest that there are widespread, systemic problems around new businesses accessing finance in Australia. Nevertheless, there are opportunities to address regulations around crowd-sourced equity and employee share schemes with a view to giving more (and potentially lower cost) finance options to new businesses. These are explored in chapter 6. Likewise, innovations that are likely to make it easier for businesses to access debt finance — such as comprehensive credit reporting and peer-to-peer lending — are explored in chapter 7.

6 Equity finance

Key points

- There is very limited use of equity finance by new businesses (other than owner equity) and for all businesses the proportion seeking external equity finance is small relative to the proportion seeking debt finance.
- External equity finance for new businesses is usually limited to funds from family and friends except where the new business is a result of a privatisation or some type of corporate restructuring activity, or established to undertake a major project development.
- For innovative and high tech businesses seeking rapid expansion, access to equity finance is likely to be crucial to their growth and success in developing new products and services.
- To improve access to equity finance for new small businesses, the Australian Government has proposed changes to the existing regulatory arrangements for employee share schemes (ESS) and is establishing a regulatory framework to facilitate crowd-sourced equity funding (CSEF).
- While widely supported by stakeholders, some concerns were raised around the Australian Government's proposed regulatory framework for CSEF, in particular that caps on the amount CSEF investors can invest may impact on the ability of issuers to raise sufficient funds and result in a large number of small investors without adequate control of the business.
  - An exemption for sophisticated investors and professional investors (as defined by the Corporations Act) from the investor cap could address these concerns while still providing protection for smaller investors.
- There were also some concerns relating to the employer eligibility requirements that apply to access the additional tax concessions under the proposed ESS arrangements. These requirements limit the concessions to new small businesses unable to access finance through listing.
  - If the Australian Government intends to provide such concessions to support new small businesses, the employer eligibility criteria applied should be strict enough to ensure that such concessions are limited (as proposed in the draft legislation) to those businesses
  - The Australian Government should subject the ESS arrangements to an independent review after they have been in operation for a suitable period to assess their effectiveness in meeting their stated objectives and their benefits relative to the revenue costs.
  - The Australian Government should also make legislative changes to remove the cessation of employment as a deferred taxing point for equity or rights granted by an employer.
- Superannuation funds are seen by some venture capitalists and business groups as a potentially larger source of funds for equity finance for new, innovative and rapidly growing businesses. Despite there being no regulatory barriers, higher costs associated with due diligence coupled with the relatively small scale of investments and uncertainty of returns has limited the investment by superannuation funds to date. Government should not intervene to mandate investment in this space by superannuation funds.

This chapter looks at the role of equity finance in business set-up, the barriers facing business in accessing equity, particularly new and smaller businesses, and options to improve access to equity finance for these businesses.

6.1 The role of equity finance

Equity finance refers to the sale of an ownership interest to raise funds for business purposes. Depending on the size of their investment, the investor may have some degree of control over the business, including through representation on the management board(s) of the business.

Relying on external equity finance means that the original owner(s) of the business are no longer entitled to the entirety of the business's economic value, including future profits, and may no longer be the sole decision maker in their business. However, unlike debt finance, the original owner(s) do not have to pay the investor(s) back as returns are determined by future earnings and can also draw on the experience, strategic advice, technical and managerial skills of their investors. Equity finance provides a business with partners with aligned incentives/motivations — for example, to maximise growth in order to increase the value of their investment — in a way that debt finance does not (beyond repaying the initial loan).

Equity finance also provides the means to enable newly established and existing businesses to expand rapidly, ahead of revenue and earnings growth. The means of providing equity finance varies from public listing on stock exchanges, which provides access to a very large number of potential investors, to newly established small businesses relying on their own equity or that of family and friends.

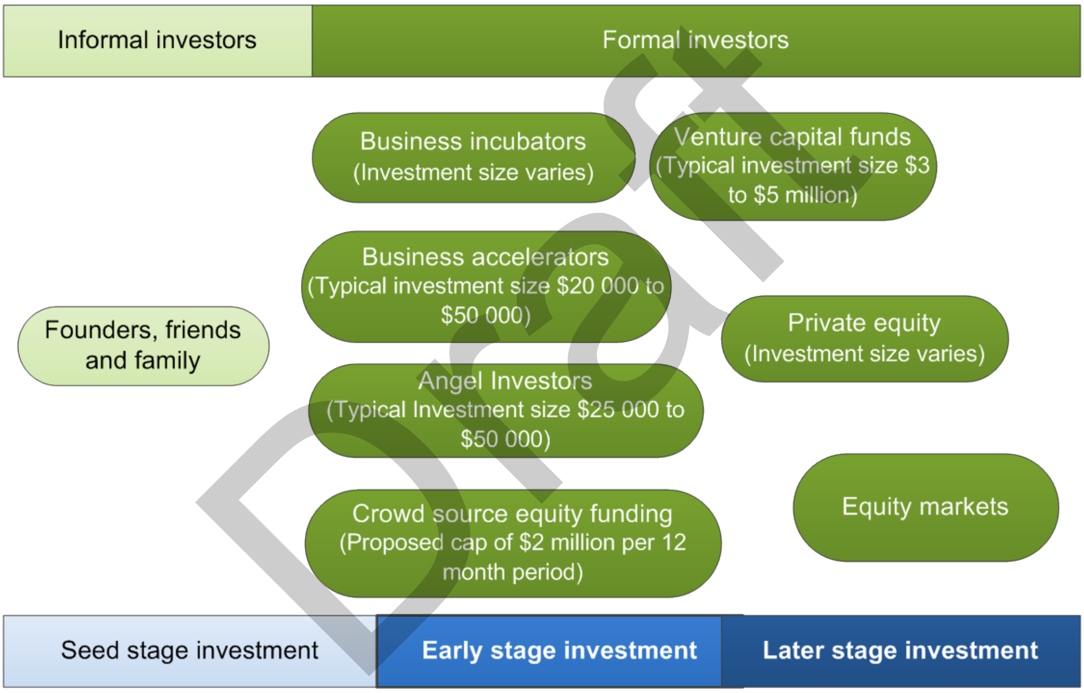
Types of equity finance

There are several types of equity finance typically used by new and established businesses:

- *Self-funding/internal equity or 'bootstrapping'*: The savings of the business owner and retained profits are widely used to fund micro and small business set-ups. This is because for many of these businesses working capital and investment needs are relatively small and there can be relatively large costs associated with raising external equity finance. That business owners have greater information about their business's prospects, risks and value than external investors and the need to pay investors a premium for their incomplete information, is a further reason micro and small business are more likely to prefer the use of internal equity or funding from family and friends (Matic, Gorajek and Stewart 2012).
- *Business angels*: Business angels are wealthy individual investors who invest their own funds, time and experience into high risk start-up businesses. These individual investors often have extensive experience in new businesses and in investing more broadly and

generally have a close involvement in the operation of the business. Mazzarol (2012a) notes that investment by business angels can provide a means to bridge the gap between funding by the founder of the business, friends and families and funds provided by later stage investors as a business grows (see figure 6.1). Although there is no regular data collection on the size of funds invested by business angels, an Australian Association of Angel Investors survey estimates that Australian business angels invested around $1 billion in emerging businesses in 2010 (Australian Association of Angel Investors 2010).

Figure 6.1 **Equity investors at the seed, early and later stage of business growth**

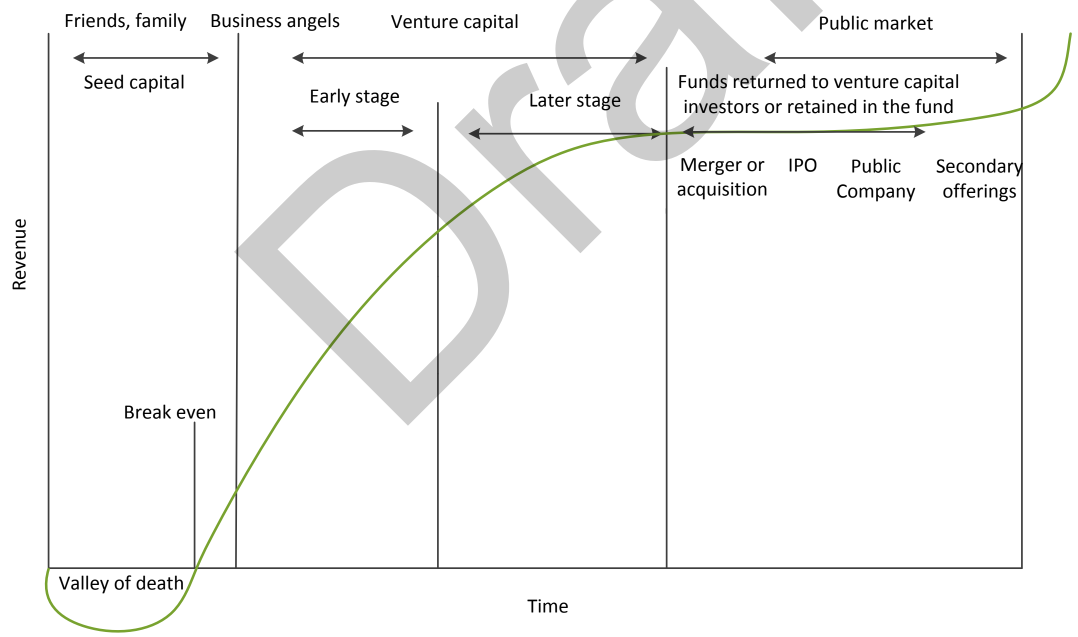


Source: Derived from OECD (2012a)

- *Venture capital*: Venture capital is a mechanism for financing new and innovative, fast-growing unlisted companies and other unlisted entities. Venture capital funds invest pooled funds in businesses in return for an equity share. These funds tend to invest in high-risk and high-return ventures that cannot obtain funds from traditional sources (The Treasury and Department of Industry, Innovation, Science, Research and Tertiary Education 2012). The focus of venture capital funds is typically to bring a new business to a stage of development where the commercial potential of the business is proven. At this point, the venture capital fund may sell its equity in the business to another party, through an initial public offering (IPO) or through a merger or acquisition (see figure 6.2). The amount of funds provided by venture capital funds are typically not large, but can represent a significant stake in the business and as such, providers of venture capital typically exert a considerable degree of control over the business (Regan and Tunny 2008). Venture capital investments in Australia were valued at $1.7 billion at the end of 2013-14, accounting for 0.11 per cent of GDP (ABS 2015a).

- *Private equity*: Private equity covers professionally managed funds and investors that make equity investments in private companies or 'buy outs' of public companies that are then delisted. Private equity investment can be used to fund new technologies and new businesses at a later stage of their development (past the initial stages where business angels or venture capital funds may have been used). Private equity investments are also made in established companies that are in distress with the aim of turning the company around before an IPO listing or selling off the company. It can also provide a conduit by which large business activities can be restructured and ownership transferred. Later stage private equity investments were valued at $6.2 billion at the end of 2013-14, accounting for 0.39 per cent of Australia's GDP (ABS 2015a).

Figure 6.2 **The role of venture capital in the growth of a business**[a]



[a] The 'Valley of death' represents the early stage of a business where the business has not yet generated the networks and profile to attract sufficient capital from external sources. At this stage, a business has not been able to commercialise their products and services to a level where their risk profile is sufficiently improved to enable sophisticated and professional investors to risk their capital in such a business.

Source: Mazzarol (2012b)

- *Public listing*: Listing a company involves the offering of securities in the company to the public. Companies list or 'go public' for a range of reasons. Public listing on an exchange provides access to new sources of capital for expansion or liquidity, provides a measurable and transparent valuation of the company, and a perception of credibility to investors as a publicly listed company (related to the ongoing requirements that apply to listed companies). In Australia, ASIC is responsible for licencing and supervising domestic financial markets. The major markets licensed by ASIC and operating in Australia include the:

- Australian Securities Exchange (ASX) operating the Australian Stock Exchange — with around 2400 companies listed at any one time;
- ASX Futures Exchange (ASFX);
- National Stock Exchange (NSX) operating out of Newcastle, catering for small to medium sized companies with just over 90 companies currently listed; and
- the Chi-X stock exchange in Sydney, which offers an alternative to the ASX and the Asia Pacific Stock Exchange (APX), focusing on access to capital in Asia and attracting Asian, particularly Chinese, investors (ASIC 2015).

- *Crowd-sourced equity funding*: Crowd-sourced equity funding (CSEF) is online fundraising that allows a large number of investors to make a small investment in a business in return for an equity stake in that business. It has been used to access funds for innovative business ideas that have had difficulties in accessing funds from more traditional sources. CSEF is considered to be a relatively lower cost means for small business to attract equity funding. As well as providing an alternative source of funding for small businesses, it can provide an opportunity for retail investors to invest in early stage financing activities without having to make a large investment (The Treasury 2014a). There are currently a number of regulatory barriers to using CSEF in Australia that are discussed below.
- *Employee share schemes*: Employee share schemes (ESS) involve employers providing their employees with shares, or options to purchase shares, in the company as part of their remuneration. Rather than providing additional new equity, these schemes reduce early cash flow demands on the company. They also align the interests of employers and employees in support of productivity, profitability and business growth. Such schemes are particularly important to financially constrained small innovative start-up businesses as they can be used to attract and retain highly skilled staff without drawing on scarce funds. Governments in Australia and overseas have provided preferential tax and regulatory arrangements around such schemes to encourage their use (The Treasury 2014b).
- *Business incubators*: Business incubators generally search for prospective start-up businesses and companies and locate them in a central physical location with other start-up businesses. In addition to office space, mentoring and support are provided, and in some cases funding is provided in return for equity. For example, the Muru-D incubator established by Telstra offers $40 000 in funding, free office space and mentoring in exchange for a 6 per cent equity stake in the business (*Australian Financial Review* 13 June 2014). Businesses are generally able remain in the incubator until they have grown to sufficient scale to relocate to their own space. The Australian Government and some state governments have funded some small business incubators typically to provide office space, shared services and some mentoring. A number of

universities also channel (often public) funds to business incubators in exchange for an equity share in the supported businesses and improved links to their education and research programs.

- *Business accelerators:* Business accelerators generally involve a 3 to 6 month program to develop or 'kick start' a new business. These are sometimes referred to as 'business boot camps'. Set-up businesses usually apply to join the program and entry is often determined by a competitive process. Support provided includes mentoring, strategic and technical support and introductions to venture capital investors. The capital provided is generally small, between $20 000 and $50 000 for a fixed equity stake in the company. For example, a Sydney based accelerator program provides $50 000 in capital in return for a 7.5 per cent equity stake in the businesses it accepts into the program. Accelerator programs focus on a range of businesses including technology based ventures, clothing and fashion ventures and other creative industries.

How important is equity finance?

There is very little use of equity finance by either nascent businesses (businesses in the process of being created and not yet established in the market) or new businesses (businesses that have been in operation for less than 4 years). Survey data from the Comprehensive Australian Study of Entrepreneurial Emergence (CAUSEE) indicates that the very small proportion of funding that is external equity finance, is mainly sourced from family and friends (see figures 6.3).

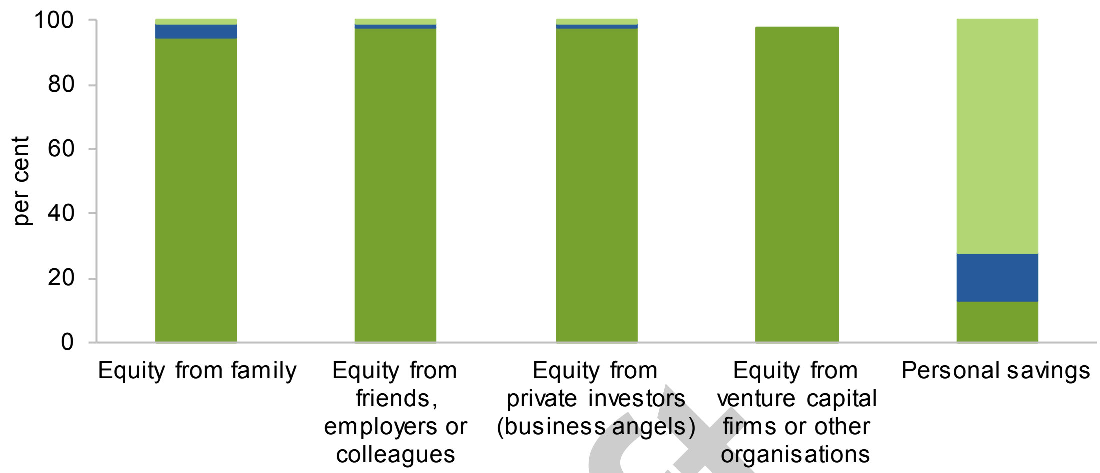
For all businesses, as noted in chapter 5, equity finance is not as widely used as debt finance and the proportion of all businesses seeking equity finance is small relative to the proportion of businesses seeking debt finance.

Equity funds from outside sources such as venture capital funds and business angels in the early stage development of a business are rarely used. Davidsson et al. (2008) noted that:

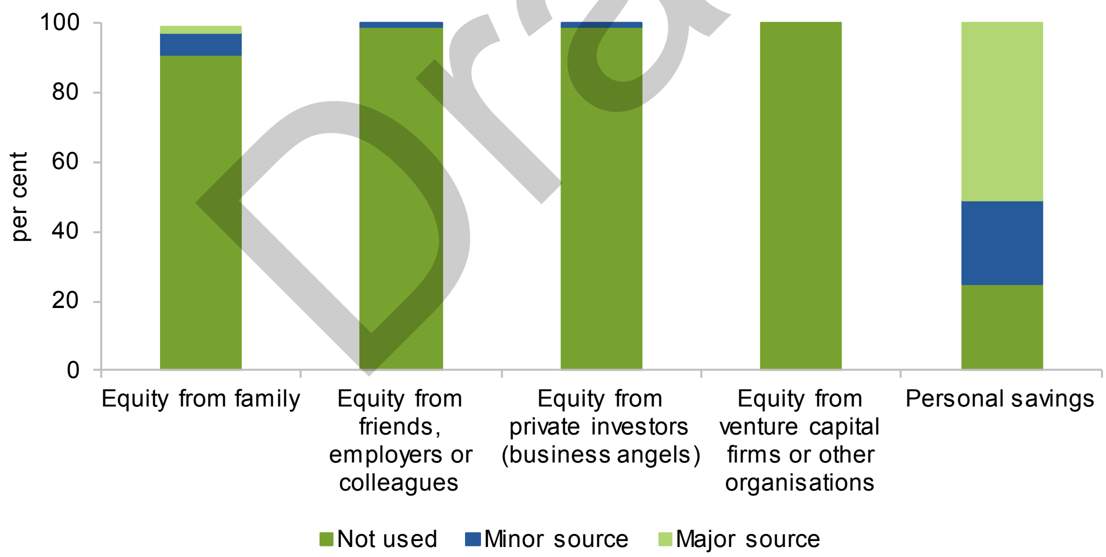
> To the extent that some might regard Venture capital start-ups entering the market with a war chest of millions as in any sense 'typical', the CAUSEE data provides a good reality check.

This highlights that most new businesses are likely to be modest in nature and reflects that the majority of businesses in Australia are micro-businesses (see chapter 2). Also, small businesses may not have the time, experience and funds to approach potential investors outside of family and friends. However, what is less clear from data on the current seeking and use of equity finance is the extent to which any barriers to its use might be discouraging businesses from investigating it as a financing option.

Figure 6.3 **Nascent business use of equity finance[a,b]**



New business use of equity finance[b,c]



[a] Nascent businesses were defined as business in the process of being created, but not yet in operation. [b] Major was defined as representing at least 20 per cent of funding needs. [c] New businesses were defined as business that had been in operation for less than 4 years.

Source: Davidsson et al. (2012)

According to Davidsson et al. (2008), there are similar findings from surveys undertaken in the United States indicating that venture capital backed start-ups are quite rare in that country (relative to the total market). Similarly in the United Kingdom, a small business survey undertaken by Department for Business Innovation and Skills (2015), noted that the proportion of small and medium sized businesses seeking equity finance was very low.

Equity finance is important for those businesses seeking to expand rapidly

There are other new businesses, including many innovative technology based companies, as well as existing businesses that may require and seek external equity capital with the specific intention of expanding rapidly. Gordon and Davidsson (2013) using CAUSEE survey data found that high potential and high growth ventures were more likely to seek external financing (both debt and equity) to develop their business than other new businesses. Although innovative high technology business set-ups with rapid growth and profit potential represent only a very small share of new businesses, access to equity funding is likely to be crucial to their growth and success in developing new products and services.

In addition to the innovative technology based start-up businesses, there are those new businesses resulting from privatisation or corporate restructuring that may also be heavily reliant on equity finance. For example, the privatisation of public trading enterprises previously owned by the Australian Government such as the Commonwealth Bank, Telstra and the Commonwealth Serum Laboratories was undertaken through the issuing of equity via a public float. State governments have also used public floats to privatise Tabcorp in Victoria and the Government Insurance Office in New South Wales. The Australian and state governments have also privatised infrastructure businesses such as airports, ports, desalination plants and electricity generators and distributors by way of trade sales (sometimes by way of long term leases). BHP in its merger with Billiton in 2001, split off its steel making division into a separately listed company, BHP Steel (now BlueScope Steel) (BHP 2001; RBA 1997).

The existence of any barriers to businesses in accessing equity finance beyond family and friends will limit new business formation and the potential for business expansion. This is not just the case for the highly technical and highly innovative set-ups that feature in the business and technology media, but for all types of business.

6.2 Access to equity finance

Participants to the inquiry pointed to a number of barriers to business set-ups accessing equity finance. These included current regulatory impediments to crowd-sourced equity funding, regulatory arrangements for employee share schemes, the costs associated with listing on major stock exchanges and the reluctance of superannuation funds to invest in venture capital.

These concerns and options to address them are discussed below.

Getting the right regulatory framework for CSEF

The Government is currently examining the necessary regulatory framework to enable CSEF to occur. This is in response to a review by the Australian Government's Corporations and Markets Advisory Committee (CAMAC) in 2014 of CSEF regulation (CAMAC 2014a) and the Financial System Inquiry's (Commonwealth of Australia 2014) recommendation that regulation should facilitate crowd-funding to provide smaller and medium-sized new businesses with more funding options.

At present, there are significant regulatory barriers to the development of CSEF platforms. The *Corporations Act 2001* (Cth) limits the number of non-employee shareholders to 50 for proprietary companies and prohibits proprietary companies from making public offers of equity. This means that proprietary companies are unable to target the large number of small scale investors necessary for CSEF. Although operating as a public company would avoid these issues, the increased compliance costs, reporting obligations and necessity for professional services associated with public listing could make this option less viable for small and medium businesses (The Treasury 2014a).

The key issue as raised by participants to this inquiry was to get the 'regulations right' to enable CSEF to occur. This requires balancing the needs of small and medium businesses to more easily gain access to funding by reducing compliance costs while ensuring that adequate investor protections are in place. CPA Australia said:

> Such a regime must however strike an appropriate balance between the financing needs of business and investor protection. (sub. 30, p. 8)

Two regulatory models have been proposed

A Treasury discussion paper (The Treasury 2014a) to facilitate public consultation as to the necessary regulatory framework raised two options for change. The first option was based on a regulatory model proposed by CAMAC. The second option was the New Zealand regulatory model that has been in place since April 2014.

- The CAMAC model is targeted at new small businesses through eligibility requirements that exempt these businesses from the existing disclosure and reporting obligations placed on public companies and provides a number of caps and thresholds to protect investors. For example, only companies with a simple structure and no more than $10 million in capital would be eligible to conduct a CSEF issue and remain exempt from the full disclosure requirements. This exemption would automatically lapse if the annual turnover of the company exceeded a predetermined minimum or the capital of the company reached a certain stipulated threshold. Businesses would be limited to raising $2 million per 12 month period to remain exempt from the disclosure requirements. Investors would be limited to investing $2500 with the one issuer in a 12 month period and $10 000 in total over a 12 month period. Intermediaries would be prohibited from having a financial interest in an issuer that is using the intermediary's website, providing investment advice to investors and from being remunerated based on the amount of funds raised.

- The New Zealand model provides for all incorporated entities to raise capital through CSEF and there are no CSEF specific exemptions from the compliance regime placed on incorporated entities. The regulatory model also places caps on the amount of funds that can be raised in a 12 month period ($2 million) by the issuer and requires investors to sign a risk acknowledgment statement. However, the regime is not specifically limited to small companies, there are only recommended caps on investors, intermediaries are able to have an interest in the issuers provided disclosure requirements are met and there are no restrictions on the fee structures of intermediaries (some examples of the regulatory models used in other countries are provided in box 6.1).

Concerns around the caps on investors in the proposed arrangements

Although the Government has not yet made a decision as to its preferred regulatory framework for CSEF, participants to this inquiry raised a number of issues around the caps placed on investors under the CAMAC model. The discussion paper noted that the caps placed on investors limiting their total investment in the one business to $2500 and $10 000 in all CSEF issues could limit the ability of issuers to raise funds, limit the attractiveness of CSEF to investors and result in a large number of small investors with limited ability to exert discipline and control over the issuer (The Treasury 2014a).

These proposed caps are to protect investors from some of the risks associated with CSEF. ASIC (sub. 20) commented that there are a number of risks associated with CSEF. This included fraud where the funds raised by the issuer were not used for the intended purpose. There is also the risk of business failure, particularly where the funded business model is unproven, the operator lacks experience or has been unable to raise funds from more traditional sources due to the high risk of the venture or poor credit history. Other risks identified by ASIC (sub. 20) included a lack of liquidity and difficulty in valuing the assets of the issuing entity due to a lack of transparency and the use of non-traditional business models. These risks are increased where investors lack the necessary experience and knowledge.

In a review of crowd funding for the International Organisation of Securities Commissions, Kirby and Worner (2014) estimated that the risk of default and/or investment failure in CSEF ventures was around 50 per cent.

CPA Australia favoured the use of the New Zealand regulatory model to facilitate CSEF in Australia with some variations to align the model with the Australian financial services regime and to reduce possible conflict of interests around intermediaries (sub. 30, p. 8).

Box 6.1 How CSEF is regulated in other countries

Canada: There are currently proposals to facilitate CSEF in Canada. The proposals are based on exempting certain companies from the existing corporations regulations with eligible incorporated companies able to issue up to $1.5 million over a 12 month period. There will be a minimum level of disclosure placed in issuers. Intermediaries or funding portals will be required to be registered, address possible conflict of interest issues and assess potential investors risk awareness. The proposals have flagged the use investor caps, both by limits on the overall amount of investment and in each CSEF issuer to limit the possible losses to retail investors.

United States: The introduction of the JOBS (Jumpstart Our Business Start-ups) Act in 2012 provided for start-up companies to raise capital through an online intermediary. However, the Securities and Exchange Commission (SEC) is yet to pass the necessary rules for the legislation to become operational.

Qualifying CSEF raisings will be exempt from the registration and prospectus requirements of the US Securities Act, but will be required to meet certain minimum disclosure requirements. Companies ineligible to use CSEF include non-US companies, companies reporting to the SEC, certain investment companies and companies without a specific business plan. Eligible companies will be capped at raising $ 1 million over a 12 month period. The intermediaries will be a new type of SEC registrant with rules covering the provision of information and prohibitions on the offering of investment advice and soliciting purchases and sales. There are investor caps over a 12 month period with investors permitted to invest up to $2000 or 5 per cent of their annual income where annual income and net worth is less than $100 000. For investors with annual income or net worth of more than $100 000, the cap is 10 per cent of their income or net worth and these investors will be capped at investing $100 000 through CSEF in any 12 months.

United Kingdom: In the United Kingdom new regulations came into effect in 2014 to facilitate CSEF. These regulations apply to all companies selling and promoting unlisted securities and limit CSEF to a relatively small group of investors. Investors are required to be high net worth individuals, retail clients advised by a regulated investment adviser or retail clients who certify that they will not invest more than 10 per cent of their portfolio in unlisted debt or securities. These restrictions in turn have reduced the level of regulation placed on issuers and intermediaries.

European Union: A number of jurisdictions have announced that they will establish arrangements to facilitate CSEF and there have been calls for an EU wide response. Italy commenced CSEF in 2012 using a regulatory model that differs in some areas from that used or proposed in other jurisdictions. CSEF is limited to ‘innovative start-ups’ (based on R&D involvement, the number of researchers employed and the business being less than 4 years old) and issuers are capped at raising €5 million per year. There are minimum investments for professional investors and/or registered financial institutions, but caps on small investors. A further feature is that ‘permitted managers’ or intermediaries have an obligation to match an investor’s profile to investment risk. Small investors (investments not exceeding €500 in each issuer and not more than €1000 in CSEF in total) are exempt from these profiling requirements provided they take a test to demonstrate they are aware of the risks of investing in CSEF.

Source: CAMAC (2014a); Kirby and Worner (2014); SEC (2013)

Can access to CSEF be improved and investors protected?

The regulatory model to enable CSEF to occur is not yet in place. The objective of the regulation proposed to facilitate CSEF is to enable small businesses to access capital and protect investors. The proposed caps on investors in the CAMAC model, although put in place to protect investors, could impact on the ability of issuers to raise adequate funds and result in the businesses utilising CSEF attracting a large number of small investors without adequate control. These caps effectively limit an investor to four CSEF investments each year — under the proposed cap each investor is limited to investing $10 000 per year in CSEF issuers and $2500 in a single CSEF issuer — and limit the ability of investors to diversify their CSEF portfolio and the spread the investment risk.

The use of a universal investor cap fails to differentiate the risk profile of investors. The use of a cap can offer protections, by capping annual losses, to small generally risk averse retail investors who may not have an adequate understanding of the risk of investing in small start-up businesses. However, for larger more sophisticated investors better able to assess the risk of various investments, the use of a cap may act a disincentive to invest in these businesses by limiting the scale of investments and hence returns relative to the high fixed costs of due diligence.

The Corporations Act currently provides exemption from disclosure where securities are offered to sophisticated investors (investors with net assets of $2.5 million or a gross income of at least $250 000 over the previous 2 years) and professional investors (a holder of a financial services licence or investors controlling gross assets of at least $10 million). Exempting those investors who meet the Corporations Act definition of a sophisticated investor or a professional investor from the CSEF cap would allow those investors with greater resources to invest in smaller businesses commensurate to their assessment of the risk and the possible return, enable these investors to diversify their risk across a wider portfolio of CSEF investments, increase the flow of available funds to these businesses and provide protection for smaller retail investors through the caps on investment. Exempting professional and sophisticated investors from the cap would bring the regulation of CSEF into line with the regulation of peer-to-peer lending (chapter 7).

An alternative approach to protect investors would be to incorporate voluntary investor caps and increased disclosure requirements for larger investments, as in the New Zealand model. Investors could also be required to declare their acknowledgment of the risks prior to investing (this is a feature of both the New Zealand and CAMAC model). A graduated use of increased disclosure requirements for larger investors would place the onus on investors to assess the risk and return, but increase the risk of all investors losing larger amounts of funds.

The Commission's preferred option is to use investor caps and an exemption for sophisticated investors and professional investors, as defined by the Corporations Act. This would provide protection for small retail investors, increase the flow of available funds and lessen the risk of a highly fragmented investor base with inadequate control.

DRAFT RECOMMENDATION 6.1

The Australian Government should introduce a two-tiered regulatory structure for crowd-sourced equity funding. The first tier would be directed at those investors determined under the *Corporations Act 2001* (Cth) to be 'sophisticated' or 'professional' and would not restrict possible investment. The second tier would be directed at other less experienced investors and would include a cap on individual investments.

Concerns around the proposed ESS arrangements

The Australian Government released a draft exposure bill in January 2015 to change the taxation of employee shares, rights and options granted after 1 July 2015. Its aim is to encourage the establishment of innovative new businesses. Specifically, the draft bill aims to make improvements to the current taxation of ESS including:

- making changes to the taxing points to the rights of shares granted to employees so that income tax payable is deferred until the rights are exercised, or employment ceases, up to a maximum period of 15 years
- additional concessions to make ESS more attractive to small start-ups through the granting of income tax exemptions on rights or shares provided to employees on a discounted basis (up to 15 per cent) and discounts on capital gains tax paid on these shares
- increasing the maximum deferral period for tax to be paid on shares and rights from 7 to 15 years
- supporting the Australian Taxation Office to work with the industry to develop and approve safe harbour valuation tables that will provide greater certainty to businesses to calculate the market value of the business at the taxing point of the shares (Australian Government 2015d).

The draft legislation limits access to the additional concessional tax arrangements to employees participating in ESS operated by businesses that are less than 10 years old, have an annual turnover of less than $50 million and are unlisted companies.

The intention of Government in making changes to the existing arrangements is to reverse some of the changes made in 2009 to the taxing points of rights to all employees, reduce the administrative costs associated with establishing and operating a scheme and provide additional tax concessions for ESS to assist small Australian start-up businesses.

The exposure draft highlights that the additional tax concessions were put in place to target those small start-up businesses without easy access to capital and assist them to compete in the labour market. The eligibility requirements around turnover, age of the company and listing are to target these businesses and the inclusion of all affiliates and associated companies to meet the eligibility requirements is to ensure the integrity of the arrangements. In excluding listed companies from the concessions, the exposure draft goes on to note that listed companies have easier access to capital and listing provides a means to value the business. Listing also demonstrates that a business is in a more developed stage where issues around liquidity are less problematic (Australian Government 2015d).

These proposed changes, in particular taxing the share options of employees when they are exercised instead of when they are granted, will address a major stakeholder concern of the existing arrangements and may enable Australian start-ups to compete with other countries to attract and retain talented staff.

The CCIQ said:

> The reintroduction of positive tax treatment of Employee Share Scheme arrangements is an example of good reform in this space, as it creates an additional resourcing avenue for entrepreneurs. Returning the legislation to its former position will see options taxed when they are converted to shares, rather than when the employee receives them. This is highly beneficial to start-ups and entrepreneurs because it allows them to attract top talent, and accelerate growth, which they would not otherwise have been able to leverage due to inadequate cash flows. (sub. 8, p. 6)

Google, in endorsing the Government's proposed changes, noted that:

> One of the major expenses for any new business entrant is staffing costs, including wages. One form of finance, especially for technology company startups, is employee share schemes (ESS). These schemes effectively enable fledgling businesses to compete for talented staff by reducing up-front staffing costs. They also incentivise staff by giving them a direct financial stake in their employers and offer the potential for financial rewards commensurate with the level of risk associated with such businesses. (sub. 37, p. 5)

Not all businesses will be eligible for the tax concessions

There have been some concerns regarding employer eligibility to the proposed tax concessions to assist small start-ups.

Determining the size of eligible business

The apparent arbitrariness of the eligibility criteria used to determine the size of the business was noted by the Law Council of Australia (2015) in its submission on the exposure draft:

> It is unclear why a turnover of $50M has been chosen or whether turnover is the best way to measure a company's eligibility for the rules. The use of aggregated turnover may unduly restrict a company's ability to qualify as a 'start-up' where it receives seed funding from a large investor that results in that investor being grouped for aggregation purposes. (p. 3)

The Tax Institute (2015) in its submission on the exposure draft was concerned that there was the potential for a start-up business to exceed the $50 million turnover cap. This could easily occur as a result of a venture capital fund acquiring a stake in the new business as the turnover cap applied to affiliates and associated businesses.

Following consultations on the exposure draft, the bill was amended so that contributions from venture capital investors or tax exempt entities with deductible gift recipient status would not rule out eligibility for the new small business concession (Bilson 2015b).

It is often quite difficult to set the 'right' threshold. Indeed, some small start-up businesses could be excluded as the use of the $50 million turnover cap could exclude smaller businesses with large turnovers, but slim margins. An alternative metric to turnover to determine business size is the number of employees. Requiring a business to have less than a certain number of employees to be eligible for the tax concessions more readily reflects a key objective of these arrangements to assist small start-ups attract and retain staff. The Commission has previously concluded that as it is not feasible or appropriate to develop a definition of small business for all regulatory purposes — regulators and policy makers are best placed to consider which businesses are 'small' for a given policy area (PC 2013e). However, a starting point to determine eligibility as a small business is to use the ABS definition of a small business as being a business that employs fewer than 20 people and this definition is used by the Australian Government's Small Business Commissioner [9].

Determining the age of eligible business

A further concern was the requirement on businesses to be 'younger' than 10 years old. This requirement could exclude those businesses in sectors with long lead times, such as biotechnology. CGI Glass Lewis in its submission (2015) on the exposure draft said:

> … the proposed concessions do not appear to account for the start-ups in industries including but not limited to biotech, pharmaceuticals, mining and technology that have long lead times between incorporation and product commercialisation. (p. 3)

The requirement for businesses to be incorporated for less than 10 years provides for the concessions to be limited to new businesses. Although a lower 'ceiling' on the period of incorporation may be sufficient to define a 'new business', this time period should not be increased as it is difficult to consider a business that has been incorporated for over 10 years as a new business. It is also unlikely that in the timeframe of many investors a business incorporated for 10 years or longer would be considered as 'new'.

9 In the European Union a small business has less than 50 employees, in Canada it is a business with less than 99 employees and in the United States it is less than 500 employees in manufacturing businesses and less than 100 in wholesaling.

The exclusion of listed companies

The exclusion of listed companies was also raised as a concern by CGI Glass Lewis (2015):

> Whilst we agree that listed entities generally have easier access to capital than unlisted entities in Australia, we also note that it is this limited access to capital that often leads entities to list in the first place, not because they have reached some critical stage of development. (p. 3)

KPMG noted that the exclusion of listed companies would impact on those start-up businesses, such as junior mining companies and technology sectors, that had traditionally listed early to gain access to capital markets (KPMG 2015).

Although some companies list early to access capital, these companies in having access to capital are not the small start-up businesses the tax concessions are explicitly targeting.

The Commission considers that basing the employer eligibility criteria on the number of employees (based on the ABS definition of a small business) rather than turnover would more effectively target 'small' businesses and the length of time the company has been incorporated (the proposed 10 years) effectively targets 'new or 'start-up' businesses. The Commission agrees with the exposure draft that excluding listed companies and applying the eligibility criteria to related companies limits the concessions as intended to those small start-ups without access to capital and that listing also demonstrates that the company is in a more developed stage. The Commission also supports, as highlighted in the explanatory material on the proposed legislation, applying the employer eligibility criteria to affiliated and associated entities to ensure the overall integrity of the arrangements (Australian Government 2015d; Bilson 2015b).

Cessation of employment remains a deferred taxing point

The proposed changes to ESS do not include the removal of 'cessation of employment' as a deferred taxing point. Several submissions on the exposure of the draft bill noted this could result in employees upon ceasing employment being subject to tax on their interests in the company and at the same time being unable to dispose of these interests to pay their tax liability. Pitcher Partners (2015) said:

> We also note that cessation of employment remains as a taxing point under the ESS provisions for both shares and rights to shares. In this regard, it is possible that employees are subject to tax on unvested shares or rights that they retain upon ceasing employment and may not be able to dispose of the ESS interests to pay their income tax liability. (p. 2)

The Law Council (2015) commented:

> In relation to tax deferred schemes, the exposure draft has retained a taxing point at the time that an employee ceases employment with the issuing employer. This can result in tax becoming payable on ESS interest before the interest is able to be realised by an ex-employee.

> In particular, sale or exercise restrictions may still apply to an ESS interest such that an ex-employee is unable to sell the ESS interest for a period after employment has ceased. However, the ex-employee will be faced with a taxing point at the time of ceasing employment. (p. 2)

Should the cessation of employment be a deferred taxing point for employer granted shares and options?

In its inquiry into executive remuneration in Australia, the Commission examined concerns around the 'cessation of employment' as a deferred taxing point for ESS. The Commission recommended that the Australian Government make legislative changes to remove the cessation of employment as a trigger for the payment of tax on equity or rights that qualified for a tax deferral. The Commission's view was that taxing the employer granted shares and options of executives on ceasing employment worked against aligning executive pay with long-term shareholder value (PC 2009b).

While the focus of that inquiry was on executive remuneration, it also recognised that ESS were for all employees, not just executives. Using the cessation of employment as a tax deferral point resulted in the different treatment of two employees holding identical, unvested and deferred rights where one retires or changes employers and the other continues to work with the same employer.

Under the arrangements proposed in the exposure draft there is a risk that employees will be subject to paying tax on unvested shares or rights when ceasing employment. This would result in tax becoming payable on an ESS interest before the employee can realise the rights to the shares or sell the shares to meet their tax liability.

Tax cannot be deferred indefinitely as there are time limits to as to how long tax payable on equity and rights can be deferred for under the ESS with the proposed scheme setting a taxing point of 15 years after the rights were acquired, unless another tax trigger has occurred. Although, there were some taxation integrity issues raised about removing cessation of employment as tax deferral point, such issues were considered not to be insurmountable (PC 2009b).

Can these schemes be justified?

The tax treatment of ESS was examined by the Commission in its inquiry into executive remuneration (PC 2009b). From a theoretical tax-neutral perspective, the Commission's view was that income tax on equity based payments should be applied at the time the rights, options or shares were granted. However, due to difficulties in valuing performance contingent unlisted rights and the Government's policy intention to provide preferential tax treatment of employee share ownership, deferral of tax was justified in certain circumstances.

The deferral of tax payable is in effect an interest free loan provided by the Government to the employee until the tax is paid, but it also reduces the value of an employee's remuneration relative to being able to receive that remuneration immediately (PC 2009b). ESS are attractive to employers as they provide a means for cash strapped businesses to attract and retain staff. The proposed tax concessions will also provide a subsidy to those eligible businesses by enabling them to compete in the labour market to attract and retain highly skilled staff without drawing on scarce capital. The Early Impact Assessment estimates that the proposed ESS arrangements — the deferral of tax payable and the tax concessions to employees of small unlisted start-up businesses — will have a $200 million cost to revenue over 4 years (The Treasury 2014b).

The proposed changes to the current ESS arrangements and the proposed tax concessions are intended to assist small innovative unlisted start-up companies access capital and attract the necessary staff to stimulate their growth. Until the proposed changes have passed into legislation and the ESS has been in operation for a period of time, it is not clear how effective it will be in meeting its objectives and how the benefits of the scheme compare to its revenue costs. The ESS should be reviewed after it has been in operation for a period of 5 years to assess its effectiveness in meeting its objectives and its benefits relative to the revenue costs.

DRAFT RECOMMENDATION 6.2

If the Australian Government intends to provide assistance to small start-up companies with limited access to capital via additional tax concessions under an employee share ownership scheme, eligibility should be based on:

- the number of employees in the company
- the length of time the company has been incorporated
- the company being unlisted
- the application of the employer eligibility criteria to related companies
- the employing company being an Australian resident taxpayer

If the Tax and Superannuation Laws Amendment (Employee Share Schemes) Bill 2015 is passed, all aspects of the taxation and effectiveness of employee share schemes should be reviewed five years after commencement of the legislation.

The Australian Government should make legislative changes to remove the cessation of employment as a deferred taxing point for equity or rights granted by an employer.

Costs associated with company listing

The costs associated with listing and the Corporations Act disclosure requirements are potentially a barrier to smaller businesses seeking access to equity finance through public listing, but were not explicitly raised by inquiry participants.

The Financial System Inquiry's interim report suggested that for small to mid–sized companies the cost of issuing equity can be prohibitive as they face disproportionate costs (larger fixed costs due to their size and promotional costs as they are relatively unknown in the market) compared to larger companies. In its interim report, the Financial System Inquiry called for input as to the appropriateness of the size and scale of offerings that could be made without a prospectus. The Corporations Act currently provides lower thresholds to the disclosure requirements for smaller equity raisings (no prospectus is required for equity offers up to a value of $2 million for 20 people over a 12 month period and for offers up to $10 million the issuer is only required to provide an offer of information statement) (The Treasury 2014c).

ASIC's view, in its response to the Financial System Inquiry's interim report, was that lowering the standard of disclosure would not stimulate equity investments in smaller companies as there was a preference by small companies to use prospectuses when raising equity. ASIC noted that in 2013-14, only 10 per cent of all capital raisings under $10 million made use of the less onerous standards of providing an information statement.

The final report of the Financial System Inquiry did not discuss the issue of lowering the disclosure requirements for smaller scale capital raisings (The Treasury 2014d).

The preference to issue a prospectus is a result of companies seeking to encourage participation in the offering by enhancing investor confidence through the provision of additional information. It also helps to protect their corporate reputation and enables the issuer to take advantage of the relevant due diligence defences available under the prospectus regime (ASIC sub. 20). ASIC considered that the risk of further lowering the standard of disclosure, or protection for investors were disproportionate to the benefits associated with such a change and would only marginally reduce the costs associated with capital raising (sub. 20) (ASIC 2014c).

Should the disclosure requirements be lowered?

As noted by ASIC, very few small capital raisings have made use of the lower disclosure requirements with the vast majority opting to issue prospectuses. As businesses engaged in small capital raisings generally opt to issue a prospectus rather than a less costly and onerous information statement, indicates that these businesses consider the higher standards of disclosure encourage and attract potential investors, enhance their corporate reputation and provide due diligence protection that outweighs the additional costs. The Commission recognises that ASIC considered that lowering standards of disclosure standards, and consumer protection, would only marginally reduce the costs associated with capital raising (sub. 20).

In the Commission's view, there does not appear to be any rationale and no evidence to support a lowering of the standards of disclosure required to raise equity.

Costs of listing on the ASX

The actual cost of listing on the ASX, including underwriting and preparation of the prospectus usually costs between 6 to 10 per cent of the funds raised (ASX 2015). There are also specific admission criteria that a company must meet to list on the ASX relating to the number of shareholders and the company size, based on a profit or asset test (table 6.1).

From the submissions and consultations with participants, the costs associated with and the eligibility requirements for listing on the ASX were not identified as being a problem for businesses. The Commission was told that template documents were used by some issuers to keep costs under control whereas other businesses and their directors took a more risk averse (and costly) approach and provided extensive information to the ASX prior to listing. Although smaller companies do incur higher relative costs when listing on the ASX, they do not appear to be onerous relative to the capital raised and the potential to raise capital in the future.

The use of secondary boards

A further means to assist smaller companies access to equity markets is through the use of secondary boards.

There are secondary boards in Canada and the United Kingdom that cater specifically for smaller listed companies. The ASX notes that Australia experimented with secondary boards between the late 1980s and early 1990s. These boards were closed as the market did not ‘gain traction’ with smaller listed companies (who it was designed to assist), and investors. The ASX presently maintains a single market catering to a wide range of companies. According to the ASX, this provides small companies with access to a large public market to access capital while providing appropriate regulatory standards to protect investors (ASX 2010).

There is also the NSX, re-established in 2000, that specialises in smaller listings and has around a 90 companies currently listed. The cost of listing on the NSX using a prospectus, typically costs between 5 and 10 per cent of the funds raised (NSX 2015). The admission criteria to list on the NSX are not as high as those for listing on the ASX (table 6.1).

The Commission notes that from its consultation processes there was no support and there appears to be little demand at present from either smaller listed companies or investors for the ASX to re-establish a secondary board on the major Australian equities market.

Table 6.1 **Admission criteria to list on the ASX and NSX**

Admission criteria	*ASX*	*NSX*
Number of shareholders	Minimum of 400 shareholders @ $2 000, or 350 shareholders @ $2 000 with 25 per cent held by unrelated parties, or 300 shareholders @ $2 000 and 50 per cent held by unrelated parties.	Minimum of 50 shareholders @ $2 000 and 25 per cent held by unrelated parties
Company size		
profit test	A $1 million net profit over the past 3 years plus a $400 000 profit over the past 12 months	2 years adequate track record or issue underwritten by an underwriter
assets test	Or $3 million in net tangible assets or $10 million market capitalisation	A $500 000 minimum market capitalisation

Source: NSX (2015)*;* ASX (2015)

Equity raising by private companies

Under the Corporations Act, private or proprietary companies are required to have at least one shareholder and no more than 50 non-employee shareholders. They are unable to sell shares to the public and their reporting requirements to ASIC are less stringent than for public companies. Small proprietary companies are generally not required to prepare audited financial statements, but larger proprietary companies are required to lodge audited financial statements with ASIC[10].

The regulations around equity raising by private companies and the related disclosure requirements were not raised as an issue by participants to this inquiry.

The reluctance of superannuation funds to invest in venture capital

Some inquiry participants and others involved in venture capital have noted that there is a reluctance by superannuation funds to invest in venture capital. Although superannuation funds manage a significant pool of funds — representing a potential flow of capital to fund innovative business set-ups — to date there has been limited investment in venture capital.

For example, the Australian Private Equity and Venture Capital Association Limited (AVCAL) in its submission to the Financial System Inquiry noted that although the domestic superannuation industry was worth around $1.75 trillion only a fraction of these funds were allocated to be invested in small business and innovative and high growth

10 A proprietary company is classified as small if it satisfies at least two of the following criteria: (i) consolidated revenue over the financial year is less than $25 million (ii) the value of the gross assets under control at the end of the financial year is less than $12.5 million (iii) the company and its entities have fewer than 50 employees at the end of the financial year.

companies. AVCAL pointed out that only 0.6 per cent of total superannuation funds under management in 2012-13 were committed to both venture capital and later stage private equity down from a high point of 1 per cent in 2008-09 (AVCAL 2014).

Superannuation funds can invest in venture capital either through venture capital funds or as a direct investor in a company. However, given the relatively modest amount of finance required by a start-up business relative to the funds invested by a superannuation fund, most superannuation funds are invested in venture capital through funds. Venture capital funds invest either directly in investee companies or indirectly through pooled venture capital funds or aggregators (ABS 2015).

AVCAL's view was that the superannuation policy settings around the portability requirement had incentivised superannuation fund trustees to allocate only a small proportion of funds to illiquid assets such as venture capital and private equity. It also claimed the MySuper default funds had in practice placed a focus on high liquidity and low fees at the expense of potentially higher longer term returns from more illiquid asset classes. These policy settings would restrict further funds flowing to venture capital and private equity vehicles that would ultimately be detrimental to superannuation fund members (AVCAL 2014).

Others involved in the tech sector have called for Government to legislate to have superannuation funds allocate a small proportion of their funds under management to tech focused venture capital funds (*Australian Financial Review*, 23 February 2015).

Poor returns have made venture capital a less than attractive investment

One factor influencing the appetite of investors, including superannuation funds, to invest in the Australian venture capital sector is poor returns. Off the 37 funds operating in Australia between 1985 and 2008 the average annualised return was –5.4 per cent (AVCAL 2009). In comparison, the average annual return provided by the All Ordinaries Accumulation Index was 13.5 per cent over the same period (AMP 2013). The Financial System Inquiry interim report (The Treasury 2014c) noted that:

> Over the past two decades or so, the returns from domestic venture capital funds have not provided investors with adequate compensation for the associated risks.

PwC (2013) also noted that venture capital funds were yet to generate sufficient funds to attract significant capital and an Australian Government review of venture capital and entrepreneurial skills (The Treasury and Department of Industry, Innovation, Science, Research and Tertiary Education 2012) found that investors had withdrawn from the sector because of the poor returns:

> Many of the larger domestic investors (such as superannuation funds) have withdrawn from the Australian venture capital market mainly because it has not delivered the returns it had promised. The expectation is that they will stay away from the market at least until returns meet their expectations (that is this trend is not likely to change in the short term) (p. 37)

The review also noted that annual investments in venture capital had declined — from over $800 million in 2007-08 to just over $200 million in 2010-11 (The Treasury and Department of Industry, Innovation, Science, Research and Tertiary Education 2012). More recently, just over $190 million was invested in venture capital in 2013-14, an increase from the $164 million invested in the previous year (ABS 2015a).

Institutional investors consider venture capital to be a highly speculative asset class (sub. 15). The investments targeted by venture capital funds are inherently high risk with highly volatile returns. For example, more recent data on the returns provided by venture capital funds in Australia show that for the 12 month period from September 2013 to September 2014 the pooled return to Australian venture capital funds was just over 14 per cent, but over the 5 year period to September 2014 the pooled return was -2.7 per cent (Information provided by AVCAL).

The venture capital industry in the United States has also experienced similar difficulties. Research by the Kaufmann Foundation indicates that only around 20 per cent of US venture capital funds produced returns that exceeded the return provided by the share market by more than 3 per cent per year and that, as in Australia, the US venture capital industry was also facing difficulties in attracting investment (Mazzarol 2012).

Other issues facing potential investors

In addition to poor returns, the Commission was advised that for a superannuation fund the relatively small scale of most venture capital investments was not commensurate with the cost and effort of due diligence typically undertaken by a superannuation fund prior to investing. The lack of a known risk profile and 'track record' for venture capital investments and the fees charged by venture capital aggregators were also a disincentive for superannuation funds. Also, the relatively small scale of most venture capital investments would require very significant returns to noticeably improve the performance of a superannuation fund and vindicate the investment decision.

The Institute of Public Accountants (sub. 32) noted that the high level of uncertainty involved in investing in venture capital compared to investments in established companies working in known industries, producing 'mature' products and services with an existing customer base.

> VCs commonly support new enterprises in 'new knowledge-based' areas of science and technology where the returns to successful companies can be extraordinarily high. In order to exploit such novel and emerging opportunities, the investors and the supported entrepreneurs and managers have to operate in markets and sectors with enormous levels of uncertainty regarding the technology, and the feasibility and attractiveness of the novel products and services produced. (p. 14)

There was also a view that there were limited opportunities for venture capital in Australia, rather than a lack of capital. The co-founder of Atlassian, considered one of Australia's recent high tech successes, said:

> Capital is not the problem. Some people can't get that capital, but I think maybe it's because they're running shitty businesses. (quoted in *The Australian*, February 23, p. 17)

The lack of 'quality deals' for venture capital in Australia was also raised by other technology entrepreneurs. Ian Maxwell said:

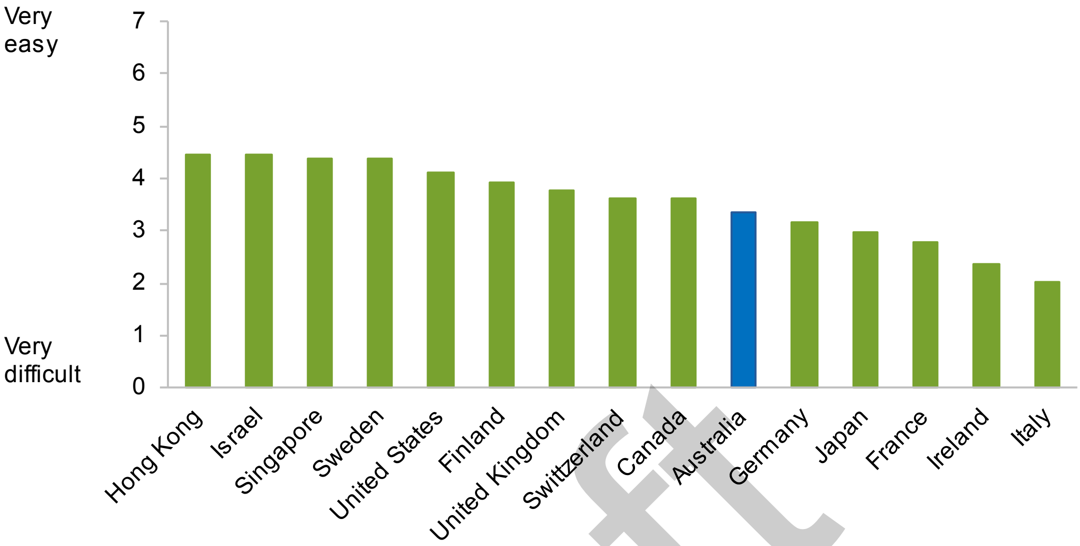
> The myth that is propagated through our media is that there are endless high quality tech opportunities in Australia but what is missing is investment capital, usually followed by calls for government to supply more of this, free of charge. Arguments for the high quality deal flow are usually accompanied by a nod to the usual chestnuts, being the Hills Hoist, the Victor lawn mower, the ute (my personal favourite), Resmed, Cochlear, and more recently Atlassian …
>
> Statistically speaking one cannot make an argument for an investment class (like VC) based on statistical outliers like Resmed or Cochlear; any argument has to be based on mean returns because all financial markets and their players regress to the mean over time. And our mean return on VC investment is negative which highlights the low quality of our deal flow. (Maxwell 2013)

In comparison to other countries, based on the World Economic Forum's Executive Opinion Survey, it does not appear to be overly difficult for entrepreneurs in Australia to access venture capital (figure 6.4).

To attempt to increase funding for the Australian venture capital industry, the Australian Government is considering changing the rules of the Significant Investor Visa (SIV) program to require those acquiring a SIV to invest 20 per cent of the required $5 million into venture capital and 30 per cent into emerging listed companies (Robb and Cash 2015). Such changes if implemented, could lower the potential returns on the required investment and thereby increase the cost of the visa to migrant investors looking to obtain a visa to Australia.

However, that is not to say that the superannuation funds should not be invested in venture capital or other higher risk long term assets. The requirements of the *Superannuation Industry (Supervision) Act 1993* require that trustees promote the financial interests of the beneficiaries or members of the funds. Different investment strategies are likely to be more appropriate to fund members depending on their time until retirement. For example, younger members with a longer investment time frame until their retirement may be more willing for their trustees to take on greater risk and focus on longer term and illiquid assets compared to those members closer to retirement who are likely to focus on less risky and more liquid assets.

Figure 6.4 **Venture capital availability, selected countries**[a]
2012



[a] The data is based on the Executive Opinion Survey conducted by the World Economic Forum. Answers to the question 'In your country, how easy is it for entrepreneurs with innovative, but risky projects to find venture capital?' were on a scale of 1 (very difficult) to 7 (very easy).

Source: World Economic Forum (2012)

Should superannuation funds be directed to invest in particular assets?

The suggestions to alter regulation around superannuation to encourage funds to invest in less liquid, higher-risk and longer-term assets, such as venture capital are likely to be at odds with the objective of Australia's superannuation system to provide retirement incomes. The Financial System Inquiry noted that the primary objective of the superannuation system is to provide retirement incomes. It recommended that the Government seek agreement to have enshrined in legislation that the primary objective of the superannuation system is, 'To provide income in retirement to substitute or supplement the Age Pension' (The Treasury 2014d).

Moreover, any mandating of asset allocation by superannuation funds would distort capital flows and result in poor performance and lower returns to retirees. Deloitte Access Economics (2013b) commented that:

> While incentives may help to maximise the economic impact of superannuation capital, mandated allocation risks leading superannuation away from its primary purpose—funding income in retirement. Market forces determine that capital will flow where it is most valued. This obviates the need for any specific interventions mandating asset allocation of superannuation fund investment strategies, as this is an invitation to poor performance and lower returns. (p. 62)

The Australian Government (2010), in its response to the Super System Review, was against directing the trustees of superannuation funds to make particular investments.

> Requiring superannuation funds to invest in particular assets would limit the capacity of trustees to pursue investment opportunities that maximise returns to members. This could reduce the retirement incomes of Australians and jeopardise the long-term success of the Government's retirement income policy.(p. 13)

As to the existing regulatory arrangements of superannuation funds biasing their investment decisions, the Commission's inquiry into public infrastructure (PC 2014d) noted that while the broader regulatory framework may alter the way that superannuation funds make investment decisions, including in illiquid assets such as infrastructure (and venture capital), this was a result of how the broader financial system was regulated, rather than an issue specific to infrastructure (or venture capital).

The Commission notes that although there are no regulatory barriers to superannuation funds investing in venture capital, the comparatively low returns on some venture capital and the relatively small investment amounts required, are likely to make venture capital in Australia an unattractive option for many superannuation funds.

DRAFT RECOMMENDATION 6.3

The Australian Government should not require superannuation fund trustees to allocate funds to particular asset classes or investments, including venture capital or small businesses.

7 Debt finance

Key points

- A range of debt finance options are available to new businesses including personal loans and credit cards, formal loans made to businesses and trade credit. Capital markets are typically only available in the context of privatisations and corporate restructurings.
- Most business lending in Australia is undertaken by major banks.
  - The Commission has not found major regulatory barriers to credit unions, building societies or superannuation funds undertaking more business lending then they currently do, however, generally there is not the appetite from these organisations to do so.
  - Interest rates for business loans from banks generally range from 6 to 9 per cent, while most credit cards range from 15 to 20 per cent. The lack of formal loan products between these interest rate ranges indicates a funding gap for business. Peer-to-peer lending is beginning to fill this gap in a small way.
  - Regulatory arrangements around peer-to-peer lending appear to be effective.
- Most lending to new businesses in Australia is collateral based (often secured against the personal real estate of the business owner).
  - There is evidence that relationship lending is declining in Australia and banks are reluctant to lend on the basis of business prospects alone, but there are no impediments to lending on such bases.
  - Declining rates of home ownership amongst younger Australians present a challenge for collateral based business lending models in the future.
- Comprehensive credit reporting — recently introduced by the Australian Government in relation to consumer credit — has considerable potential to make it easier for new businesses to obtain debt finance.
  - As identified in the Financial System Inquiry, the voluntary nature of comprehensive credit reporting means there is merit in reviewing the lending industry's participation in the scheme in the near future.
- Empirical reviews of credit guarantee schemes operating overseas have failed to conclusively show that such programs materially increase the number of loans made to new or small businesses. The effect on the rate of business success is ambiguous and these schemes create undesirable distortions in the lending market.
- Government backed or operated concessional loans made to new businesses are unlikely to substantially increase (and through distortions introduced, could even decrease) the number of new businesses operating in Australia. Such programs should cease unless a market failure can be demonstrated and clear and persistent net benefits shown. Programs that provide concessional loans to new businesses in particular industries or localities likely impose net costs on both the local and broader community and should be ended.

7.1 The use of debt finance by new businesses

Debt financing is important for nearly all businesses

Of businesses that sought external finance in 2012-13, over 90 per cent sought debt finance (ABS 2014g). As of September 2014, outstanding bank loans to business exceeded $780 billion. In the September 2014 quarter, new bank lending to business was over $90 billion (representing just under 12 per cent of total business lending by banks) (RBA 2015c). The amount of debt sought through bonds is also substantial, with $233 billion Australian corporate bonds estimated to be outstanding as of December 2013 (Debelle 2014).

Businesses utilise debt finance to begin, improve or expand their business — for example, to buy or upgrade productive assets and equipment, or to move into new markets. Given this, having sufficient access to debt finance is important for business performance and productivity, which has flow on effects for the Australian economy as a whole.

Most debt used to start a business is personal debt

Personal forms of credit rather than business credit are more important for nascent businesses.[11] From the Comprehensive Australian Study of Entrepreneurial Emergence (CAUSEE), the most common sources of debt financing used by nascent businesses are:

- personal credit cards (used by 46 per cent of cases)
- personal secured bank loans (16 per cent of cases)
- other forms of personal bank finance such as overdrafts or unsecured personal loans (15 per cent of cases).

In contrast, only 8 per cent of nascent businesses use secured bank loans to the business itself and 6 per cent use other business loans and overdrafts (Davidsson, Gordon and Steffens 2012).

The prevalence of new businesses founded with personal debt finance can be largely explained by the hesitance of lending institutions to lend significant amounts of money unless it is secured with collateral. For established businesses, this collateral may be sourced internally, such as through business assets or goodwill. New businesses, however, typically do not have sufficient assets to a secure a loan, and therefore, collateral is often sourced from the personal assets of the business founder — for example, a private home.

[11] The CAUSEE study defines a nascent business as ‘firms in the processes of being created, but not yet established in the market’.

Not all debt is formal business loans

There is no doubt that lending from banks and similar deposit taking institutions represents an important source of funding for Australian businesses, including new businesses. It is also the form of debt finance most discussed by inquiry participants in submissions and consultations. As a consequence, this chapter largely focuses on bank lending and its close substitutes.

That said, it is important to recognise there are a number of other sources of debt that might be used by a new business beyond formal loans. These include:

- *Trade credit* — this occurs when a supplier allows a business to delay payment for goods and services received for a certain amount of time. Trade credit is an important source of finance for Australian businesses, with the Reserve Bank of Australia estimating that the total amount of trade credit outstanding exceeded $80 billion as of March 2013 (Fitzpatrick and Lien 2013).
- *Corporate bonds and debentures* — this involves a business raising funds by sourcing debt directly from the market, without the use of a bank or intermediary. By their nature, bond floats are more suited to large businesses that have assets, stable revenue streams and a proven credit record. Unlike bonds, debentures may not be secured with assets, however, the regulatory requirements and costs around issuing debentures means that they are generally unsuitable for new businesses. Such instruments are also not suitable for small capital raisings.
- *Revenue based financing* — this form of finance involves a business receiving finance in exchange for an amount of future earnings, up to an agreed cap. Repayment is tied to the revenue of the business – so in times of high earnings, the business repays more than in times of weaker earnings.
- *Factoring* — this involves a business selling its accounts receivable to a third party at a discount. The business selling its accounts receives money immediately rather waiting for payment, while the purchaser makes a gain when the accounts are paid.
- *Family and friends* — CAUSEE data indicates that about 14 per cent of nascent businesses obtained debt finance from family or friends of the business owner (Davidsson, Gordon and Steffens 2012).
- *Leasing* — while not strictly a form of debt financing, leasing nevertheless has similarities and is often viewed as a substitute for finance. When leasing, a business rents an asset from a lessor for a fixed term, often (with the exception of real estate) with the option or obligation to acquire ownership of the asset once the lease has expired.

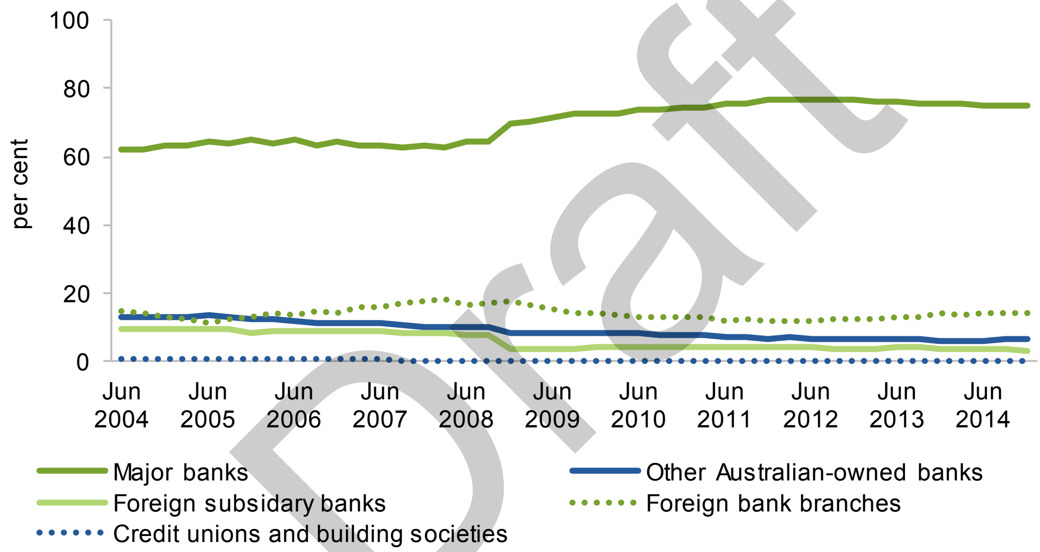
7.2 Debt finance issues for new businesses

Competition for business lending

Banks dominate business lending …

Almost all business lending in Australia is undertaken by banks — either Australian or foreign owned. The proportion of business lending undertaken by credit unions and building societies is negligible (figure 7.1).

Figure 7.1 **Business lending by institution type**



Source: Data supplied by APRA

Participants in this inquiry proposed that the reason for the dominance of banks in business lending relates to its relative complexity. Effective business lending requires an ability to judge the likelihood of a business succeeding, which in itself requires knowledge about the fundamentals of the business, the industry, regulatory environment and geography it operates in, and current and future economic conditions. Given this, larger banks — with greater resources and experience in this space — generally have an advantage in business lending. Scale and the ability to secure and maintain a more diverse loan book are additional benefits that are able to be achieved by larger banks.

… non-bank institutions and superannuation funds generally do not have an appetite for business lending …

The business models of other deposit taking institutions such as credit unions and building societies tend to be orientated towards personal finance such as savings and transaction accounts and mortgages. The Commission understands that there are very few regulatory barriers (beyond the economy wide prudential standards) preventing non-bank authorised deposit-taking institutions (ADIs) from providing debt to business should they consider such loans as worthwhile. Rather, it appears that most credit unions and building societies do not have a desire or the expertise to expand their business lending.

Similarly, the Commission has not found regulatory barriers that materially prevent superannuation funds providing debt finance for new businesses. However, consultation with the industry has suggested the appetite to do so is generally not strong. This may well reflect the fact that they can achieve similar exposures through direct bond and managed fixed investments without the illiquidity associated with direct lending to businesses.

There is some commonality in why non-bank ADIs and superannuation funds have a relatively subdued interest in business lending — large-scale business lending requires a significant upfront investment in skills and resources, and an ongoing resource commitment to undertake due diligence.

- Studies have shown that businesses in Australia value long term relationships when nominating banks to undertake transactions with (more so than in other countries) (Lam and Burton 2005; Trayler, Nielsen and Jones 2000). Given the existing dominance of major banks in the business lending space, this may act as a disincentive for non-bank ADIs to pursue a larger share of business lending.
- Under the Basel II and Basel III prudential frameworks, capital requirements for home mortgage loans are generally lower than for business loans (Gorajek and Turner 2013). For non-bank ADIs — that have relatively limited resources compared to larger banks — this may create incentives to focus their lending portfolio on mortgage loans.
- Superannuation funds have an obligation to undertake due diligence when making investment decisions. The average size of non-self-managed superannuation funds is over $5 billion (ASFA 2015). This makes undertaking due diligence, vetting and monitoring of loans to individual businesses difficult and costly (given the number of loans that would need to be assessed to achieve a material return). At the other end of the spectrum, small self-managed superannuation funds may not have sufficient assets to lend to businesses while maintaining an acceptable level of diversification.

… but new lending technologies are emerging

Despite the lack of appetite by some market participants, there are innovations in the debt finance market that have the potential to improve the ability of new and small businesses to source debt funding. One of these is the emergence of new lending platforms. As one example, PayPal now offers working capital loans to merchants that have held accounts with the service for at least 12 months. Up to 8 per cent of annual PayPal sales can be borrowed, with a fee — rather than interest — levied for the service. Collateral is not required (Drummond 2014; PayPal 2014). That said, the need to have maintained a PayPal account for a period reduces the scope for very new businesses to get a PayPal loan. PayPal joins a range of other platforms that offer (or have indicated that they intend to offer) short term loans to small businesses in Australia, including OnDeck, Moula and Prospa (Drummond 2015).

Another emerging source of debt finance is peer-to-peer (P2P) lending. While exact figures on the size of Australia's P2P market are not readily available, a major platform (SocietyOne) has indicated that they have experienced loan demand of more than $90 million since launching in 2012, with the industry tipped for considerable growth in the near future (Eyers 2015; Yeates 2014). P2P lending operates under two main models (box 7.1).

The issue of P2P lending regulation was examined in the Financial System Inquiry. The interim report was largely supportive of the current regulatory arrangements:

> ASIC has recently been working with peer-to-peer (P2P) lenders to develop appropriate regulation. Entrants in the nascent Australian P2P lending market submit that regulation is valuable in ensuring the industry begins with and maintains high standards. Existing regulation is not seen as an inappropriate barrier to entry, but rather a mechanism for ensuring new entrants are competent. Regulation is perceived as lifting industry standards and enabling operators "to compete based on providing better products and services to customers". Submissions from P2P lenders voice support for the current regulatory regime, noting its importance for protecting customers and providing industry with guidance. In this way, regulation can help develop a well managed, innovative industry. (The Treasury 2014c, pp. 4–48)

In the final report, the Financial System Inquiry did not comment on the regulatory environment for P2P lending, other than to note:

> For peer-to-peer lending, the current MIS [Managed Investment Scheme] regime may be able to accommodate different types of platforms … where investors choose to lend to specific ventures. Consideration should be given to graduating the MIS regime, but also to facilitating other mechanisms for direct lending, with policy settings consistent with securities-based crowd-funding. (The Treasury 2014d, p. 180)

Box 7.1 Peer-to-peer lending models

Most P2P lenders operate under one of two forms:

- *Collective investments* — the operator of a P2P platform forms contracts with both the investor and the borrower, and enters the loan contract with the borrower as the credit provider (as the responsible entity of the collective investment to which the investors have contributed). The Australian Securities and Investments Commission (ASIC) notes that operators of platforms that use this model are likely to require an Australian Financial Services Licence (AFSL), an Australian Credit Licence (ACL) and to register the managed investment scheme.
- *Direct loan agreements* — the P2P platform operates as a market and protects the anonymity of borrowers and investors, but the loan is provided by the investor themselves. Depending on the nature of these businesses, financial market licensing may be required, however, the operator may not be considered to be operating a managed investment scheme. If investors carry on a business of providing loans to consumers, they may need to hold an Australian Credit Licence. This model is not currently operating in Australia.

Another way to categorise P2P lenders is if they operate in the wholesale or retail market:

- *Wholesale platforms* — that are open only to professional and sophisticated investors[12]. These schemes, do not have to be registered with ASIC nor produce a Product Disclosure Statement for investors. Most P2P lending platforms currently operating in Australia are wholesale platforms. The operator will need an Australian Financial Services License and — depending on whether they are lending to consumers — may also require an Australian Credit Licence.
- *Retail platforms* — that are open to retail investors, and consequently face considerably more regulation. These regulations include obtaining licences (once again, an AFSL and ACL is needed), registering the managed investment scheme with ASIC and producing a Product Disclosure Statement for investors.

Source: ASIC (sub. 20), pers. comm RateSetter 4 March 2015, pers. comm ASIC 30 April 2015

Submissions to the Financial System Inquiry also supported the existing regulatory framework around P2P lending. For example, SocietyOne submitted:

> SocietyOne has successfully set up a P2P lending business within the existing regulatory framework.
>
> We don't believe the current regulatory framework is a barrier to P2P models. On the contrary, we believe that the current regulatory framework provides appropriate protection for consumers and guidance for P2P lenders. (SocietyOne 2014, pp. 14–15)

The Commission has not been able to find any substantive barriers to the operation (and growth) of P2P lending in Australia. However, the Commission would value further feedback about the effectiveness of current P2P regulation.

12 In the context that it is used here, a *professional investor* ordinarily controls at least $10m of funds and/or holds a financial services license. A *sophisticated investor* is an investor who is investing $500 000 or more, or who is certified by an accountant as having at least $2.5m of assets or income of over $250 000 for each of the last two years (pers. comm. RateSetter 4 March 2015).

INFORMATION REQUEST

Are current regulations around peer-to-peer lending efficient and effective? Are there any barriers — regulatory or otherwise — that restrict the operation and growth of peer-to-peer lending in Australia?

Collateral-based lending vs other lending models

When a lender is deciding on whether to provide debt finance to a new business there are a variety of factors that may influence their decision. These include:

- The *prospects of the business*. A viable and successful business is more likely to meet loan commitments than a struggling business and as such, lenders have an interest to invest in businesses that are likely to be profitable. In making an assessment about the creditworthiness of a new business, lenders may assess a business's future cash flow or profitability, growth prospects and business plan.
- The *relationship the lender has with the business*. Relationship lending involves banks building up private information about potential borrowers through repeated interactions with the business and its owners. This information is then used to inform their decisions about whether or not the business applicant represents an attractive investment (Garriga 2006). While many new business owners would not have an established relationship with a bank, some new business owners may. Such relationships might arise, for example, from the owner being a customer with the bank while operating a previous business, or a longstanding customer with the bank on a personal banking basis.
- The *collateral offered by the business*. The amount of weight lenders place on the provision of collateral is mixed (box 7.2). Regardless, it is clear that most small business lending is secured — about three-quarters of small business lending is secured with collateral, with about two thirds of this secured with housing (Connolly, La Cava and Read 2015). Given the nature of the uncertainty of investing in new businesses (chapter 5), the proportion of loans to new businesses secured with collateral is likely to be higher than for established businesses.

Box 7.2 **The weight lenders place on collateral**

In their study on the effects of housing prices on business formation in Australia, Connolly, La Cava and Read liaised with lenders to examine what factors influenced their lending decisions. On the issue of collateral, they found:

> In contrast to the first two factors [the character of the borrower and the capacity of the borrower to service debt], which the lenders uniformly agreed were crucial in lending decisions, there was some divergence regarding the importance of the *collateral* provided by the borrower, particularly in the form of residential housing. Some lenders downplayed the importance of collateral, arguing that it was just a 'back stop' that could reduce the loss for the lender in the event of default, without affecting the probability of a default occurring. In addition, some emphasised how costly and 'undesirable' it was to take possession of a business owner's home upon default. These lenders viewed taking possession of the home as a third and final line of defence, after the borrower's capacity to repay has been exhausted, and after any other collateral, such as commercial property or equipment, has been sold to recover the value of the debt.
>
> In contrast, some institutions viewed housing collateral (or even just home ownership itself) as essential, particularly when making larger loans. These institutions highlighted that the provision of housing collateral was an indicator of the borrower's character; it provided the small business borrower with strong incentives to repay, with the borrower clearly having 'skin in the game'. In this way, housing collateral was seen as not just reducing the loss given default for the lender, but also the probability of default. In addition, some lenders viewed home ownership as a positive signal of the borrower's ability to accumulate wealth and as an indicator of the entrepreneur's capacity to repay debt. Even if the home was not explicitly provided as collateral against a business loan, home ownership provides the entrepreneur with a channel for raising additional funds if business revenues fall.

Source: Connolly, La Cava and Read (2015, p. 3)

Views on the lending models of banks

In consultations with the finance industry, the Commission has been told that the most important factors that banks consider when assessing loans applications is the character of the applicant and the serviceability of the loan.

However, several participants contend that collateral-based lending has become the norm and that banks have not widely embraced an assessment of the fundamentals of a business as a basis for lending decisions (box 7.3).

Deloitte Access Economics note that the adoption of a formulaic approach to business lending may impact on the ability of new and small businesses to access debt finance:

> A pure focus on pre-determined KPIs would fail to internalise the idiosyncrasies of a business. Moreover, such a system would tend to favour established, stable businesses that have enough security, cashflow and a credit history. Such a system would be less adept at assessing the potential worth of a start-up (e.g. without tangible assets or cash flow), a business with no credit history (i.e. has not used external finance) or firms with untested products (e.g. an innovation). (Deloitte Access Economics 2013a, p. 40)

Box 7.3 Participants comments on bank lending decisions

The Chamber of Commerce and Industry Queensland (sub. 8) submitted that:

> It has become increasingly difficult for small business owners to secure lending without providing significant security, which generally includes personal assets such as the family home … Access to financial institutions for start-up funding is generally limited to personal credit card loans or small personal loans, which do not require assessment of the business venture for which the funds are used. (p. 6)
>
> Assessment of a small business' creditworthiness needs to go beyond the inherent risk profile at an industry level to better reflect the specific risks of the actual business … If a start-up is succeeding, and additional finance is sought, that business should be assessed on its own merit rather than using standardised loan to value ratios. Other factors such as the ability of the business cash flows during peaks and troughs and the potential for growth in changing markets are important considerations that are currently not including in credit assessments. (p. 7)

The Australian Small Business Commissioner (sub. 10) presented similar concerns:

> For start-ups, the issue is that there is not a financial history in the particular business. For businesses lacking collateral, the issue is the bank cannot leverage existing property as security. In both these instances good, viable and profitable businesses can fail to obtain debt funding as a result of the inflexibility of financial institutions and a failure to investigate and give weight to business viability. (p. 8)

However, the National Australia Bank (sub. 7) commented that relationships were still valued and overall, the proportion of successful loan applicants is high:

> NAB accords a high premium to our long-term relationships with customers by supporting them through good times and more challenging periods.
>
> In the year to March 2014, NAB accepted 97% of the 8943 applications by small businesses for business lending of up to $1m. (p. 4)

While the Commission accepts that a focus on collateral-based lending rather than lending on the basis of business prospects or relationships may make it harder for some new and viable businesses to secure bank loans, it also acknowledges that (subject to legal and prudential requirements) how banks make their lending decisions is a commercial decision for them.

If banks were to adopt an approach to lending that examined the detailed merits of each individual business, this would likely entail additional costs — banks would have to spend more time acquiring information and analysing the creditworthiness of the business. There may be additional benefits too if, for example, this approach allowed banks to make performing loans to businesses that would otherwise be declined under conventional lending models.

Banks are in the best position to judge the relative magnitude of these costs and benefits. At present, at least among larger banks, model-based lending appears to dominate, potentially because:

- model based lending, on the whole, is viewed to involve lower administrative costs

- for small loans (which are typically sought by small businesses), the additional interest that may be earned through having a relationship-based loan (rather than no loan) may not be enough to justify the additional cost and effort of establishing this relationship
- many small businesses favour quick responses to their loan applications, and an individual assessment of a business's prospects is not conducive to this (Deloitte Access Economics 2013a)
- there may be organisational inertia within large banks that make it difficult for them to assess business loans in a way that examines the particulars of each applicant.

Overall, however, the Commission has found no regulatory impediments to banks making more lending decisions on the basis of the prospects of individual businesses, should banks view this as commercially viable.

Home ownership is falling amongst younger Australians

An emerging trend relevant to the reliance on collateral for new business lending is the declining proportion of home ownership by younger Australians who will form the cadre of business owners in the future. Between 1995-96 and 2011-12, the proportion of 15 to 34 year olds that own their own home has shrunk from 10 per cent to under 2 per cent, while the proportion that rent has increased from 55 per cent to 60 per cent (ABS 2013c).

This declining trend in home ownership amongst younger Australians has the potential to change the way banks lend to business owners. Should banks continue to be approached by potential business owners seeking finance for viable and profitable businesses, but with little or no personal equity to use as collateral for a loan, this may instigate a movement towards other lending models that do not emphasise collateral, such as relationship banking or P2P lending.

In limited circumstances, banks may allow a third-party guarantor on a loan, thereby improving the chances of a business owner obtaining a loan with little or no collateral, although this practice is not currently widespread. As Connolly, La Cava and Read (2015) state:

> Lenders are less likely to accept third-party guarantees due to the rigorous due diligence expected by the courts. In recent legal cases, for a guarantee to be enforceable, lenders are expected to have made the guarantor properly aware of their obligations. In addition, when assessing the loan application, lenders are expected to have formed an opinion that not only the borrower, but also the guarantor, has the capacity to repay the loan. Given this high burden of proof, some lenders no longer consider third-party guarantees to be a viable means of improving access to finance for young entrepreneurs. (p. 8)

Lending overseas

Anecdotally, the Commission has heard that it appears easier for new businesses in other developed countries to obtain finance than in Australia. Unfortunately, there is little evidence available to confirm or refute this hypothesis. Rankings provided by the World Economic Forum suggest that Australia is above average on the ease of obtaining a bank loan with only a good business plan and no collateral. Australia's rank (17) is not materially different from that of the United States (14), but is above a number of other advanced economies including Israel (23), Germany (26), the United Kingdom (29), Japan (35) and France (38). Countries that are ranked higher than Australia tend to be from high growth East Asian and Middle-Eastern economies, and the Nordic countries (World Economic Forum 2012).

Differences in businesses' access to credit across different economies are influenced by a range of factors such as macroeconomic conditions (that can affect the supply and demand of credit) and government policies around SME finance. The extent that countries embrace innovative lending models (such as P2P lending) can also have an impact.

Another factor that impacts on the ease of access to finance is the composition of the banking industry. For example, Kysucky and Norden (2014) find that the benefits of relationship banking (in terms of higher credit volume and lower loan rates) are more likely when bank competition is high. Related to this, numerous overseas studies support the idea that relationship lending is more suited to (or more undertaken by) smaller banks (Berger et al. 2005; Mudd 2012; Uchida, Udell and Yamori 2009). This contrasts to Australia's relatively concentrated banking system, where large banks constitute the bulk of business lending and smaller institutions (credit unions and building societies) typically focus on personal banking.

Another source of difference between countries that can impact on the ability of entrepreneurs to access debt finance is the ease that residential equity can be established to use as collateral. A number of studies draw positive relationships between home ownership and/or home equity and business formation including Corradin and Popov (2013 with US data), Schmalz, Sraer and Thesmar (2013 with French data) and Jensen, Leth-Petersen and Ramana (2014 with Danish data). In Australia Connolly, La Cava and Read (2015) also find a positive correlation between housing prices and business formation, although the effects are relatively small.

Given that mortgages are the most common instrument used to purchase residential property, the design and operation of mortgage markets may conceivably have an impact on business formation. However, the extent that differences in mortgage structures across countries influence business formation, does not appear to be substantially explored in the empirical literature.

The cost of debt finance

Some participants suggested the cost of debt finance was a factor impeding the establishment of new businesses. In their submission to this inquiry, the Australia Trucking Association (sub. 13) stated that:

> There is also evidence that many small businesses turn to high cost methods of accessing finance such as credit cards. (p. 12)

Restaurant and Catering Australia (sub. 21) commented:

> Businesses in the restaurant, café and catering sector have significant issues accessing finance at a reasonable cost. Most business owners are forced to borrow from individuals in the business that have mortgaged their homes to provide the capital required. Others, looking for small amounts, are asked to draw down on credit cards to cover the cost of capital acquisition. (p. 11)

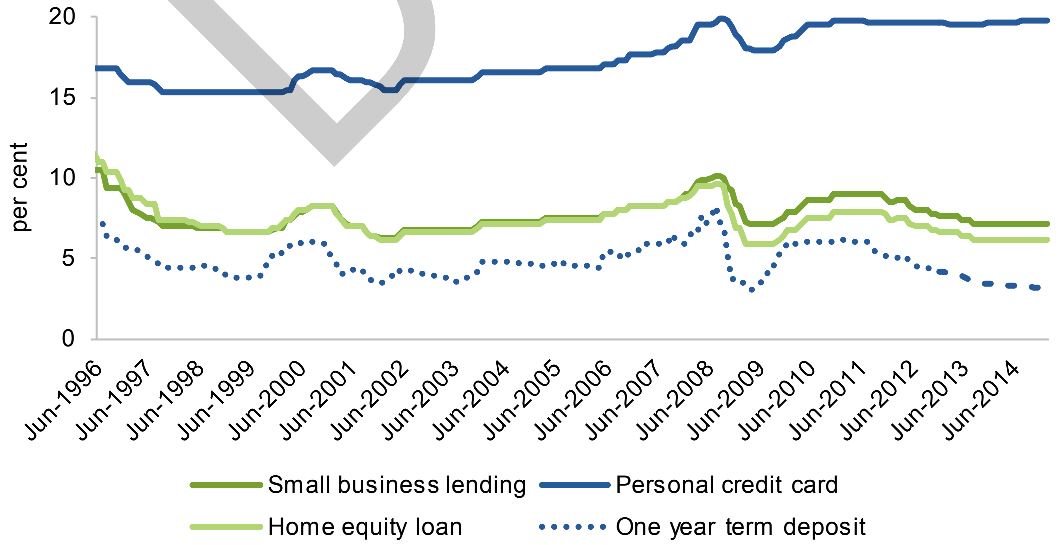
As part of their submission to the Parliamentary Joint Committee on Corporations and Financial Services Report into Access for Small and Medium Business to Finance, ACCI presented:

> Heavy reliance on credit card finance also means that business owners are paying more than double the interest rate charges for credit card finance than a residentially-secured business loan, which puts significant pressure on small business. (Parliamentary Joint Committee on Corporations and Financial Services 2011, p. 9)

Interest rates on business loans

The Reserve Bank of Australia publishes indicator interest rates on credit that includes business lending (figure 7.2). As outlined in chapter 5, most new businesses are established with personal savings, but investing savings in a new businesses has an opportunity cost. The opportunity cost of using personal savings in a business is indicated by the return on bank deposits. In January 2015, the indicator rate on one year fixed term deposits was 3.05 per cent per annum.

Figure 7.2 **Indicator interest rates[a]**



[a] The 'small business lending rate' as defined by the RBA represents 'the predominant or average indicator rates offered by major banks on loans to small businesses'. This rate relates to variable, residential–secured loans. Personal credit card rates refer to standard (that is, non-low rate). Home equity loans represents indicator rates on 'revolving, variable rate loans secured by residential property. The one year term deposit is for deposits of $10 000.

Source: RBA (2015c)

The most important sources of debt finance for new businesses are home equity loans (with indicative interest rates currently around 5 to 6 per cent) and personal credit cards (with indicative interest rates around 20 per cent). Direct loans to small businesses have indicative rates of around 7 per cent. Since these interest rates are indicators only, the actual rates available to businesses may be higher or lower than these rates, depending on the particulars of their loan.

To illustrate the variability in interest rates, the Commission has collected a subset of lending rates offered to Australian businesses by the big four banks (table 7.1). This table should not be viewed as a comparison of loan rates — different loans have different features that can be factored into their price — but does serve to illustrate the variability in loan rates. Banks may also add a premium or margin to rates depending on the type or amount of security provided or the term of the loan.

Table 7.1, however, illustrates there is a sizable difference in interest rates for residentially secured lending versus non-residentially secured or unsecured lending, and this can be viewed as a form of risk reflective pricing — where the price for credit is positively related to the likelihood of the loan underperforming and the loss if the loan does default. Risk reflective pricing is typically considered to be desirable, and a sign of the credit market working because it allows good credit risks to access finance at lower interest rates, while relatively riskier applicants can still access credit, albeit at a higher price. As a result, this reduces the effects of moral hazard and results in a deeper credit market. It would be expected that larger businesses with an established credit history would be able to negotiate loan rates at the lower end of the spectrum.

Table 7.1 **Published interest rates on business loan products**
As of 24 April 2015

Institution	*Loan product*	*Interest rate (per annum)*
Commonwealth Bank of Australia	BetterBusiness Loan (secured by residential property)	6.15
	BetterBusiness Loan (secured by non-residential assets)	8.23
ANZ	Business Saver (residentially secured)	6.91
	Business Advantage (unsecured)	9.41
Westpac	Small Business loan (secured)	5.65
National Australia Bank	Business options(prime rate)	5.72

Source: ANZ (2015); Commonwealth Bank of Australia (2015); NAB (2015); Westpac (2015)

Evidence of a funding gap?

Several participants told this inquiry that often new businesses seeking a business loan are offered access to a credit card instead. Again, depending on the particulars of the product, credit card interest rates vary — an examination of the business credit cards offered by the major Australian banks indicates that rates on most cards range from 15 to 20 per cent per annum.

Credit cards represent high cost alternatives to business loans (especially residentially secured business loans). The size of loans available through credit cards is also usually less than a formal loan and repayment schedules are different. Consequently, while many businesses would prefer a credit card over no credit, their first preference would be a formal business loan.

This inquiry has heard repeatedly from the finance industry that lenders have an incentive to make profitable loans, because this is an important source of their earnings. While the small business lending market is deemed to be more concentrated than the household lending market, there is still competition amongst lenders to secure profitable business loans.

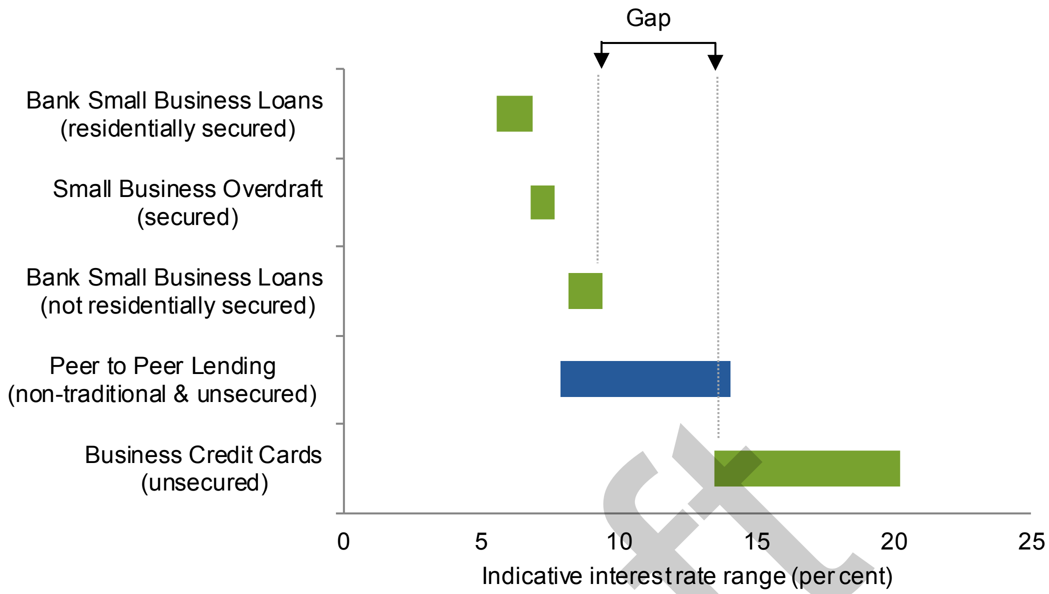
For some businesses that are being ushered onto credit cards, rather than a formal business loans, this may because their business prospects, business plan or lack of collateral mean that a credit card is the most appropriate debt product. Other businesses may have business prospects conducive to a lower interest rate, but due to banks' inability or unwillingness to fully price on the basis of risk, are forced onto credit cards. To the extent that this is happening — and this is not possible to quantify — this represents a gap in the debt financing market.

If meeting this funding gap is profitable, it is reasonable to expect new and existing lending institutions would make these loans. This is already starting to happen with the growth of P2P lending, at indicative interest rates that sit in between the rates offered by banks on formal business loans and credit cards (figure 7.3).

This assessment is supported by the Financial System Inquiry that noted:

> To the extent that some banks cannot source sufficient funding on commercially attractive terms to meet demand, market mechanisms such as the price of credit will attract alternative providers of funds, for example superannuation funds and other investors lending directly, greater prevalence of market-based financing or peer-to-peer lending. (The Treasury 2014d, p. 15)

Figure 7.3 **Indicative advertised interest rates by loan type**[a]



a Given that most business lending in Australia is undertaken by major banks, the Commission has focused on these institutions. Analysis based on advertised rates – banks may elect to offer a discount or a premium depending on the nature of the application. Rates that have been discounted for limited time periods or introductory rates have been excluded. The range of P2P lending rates have been determined through the publically available rates of RateSetter and SocietyOne. P2P lending is in blue because it represents an emerging source of funding for businesses.

Source: ANZ (2015); Commonwealth Bank of Australia (2015); Mozo (2015); NAB (2015); Westpac (2015)

7.3 Options for improving access to debt finance

The role of comprehensive credit reporting

The Australian Government has recently changed the information that can be included in credit reports by introducing what is known as comprehensive credit reporting (CCR) (box 7.4).

In short, these changes — if substantially adopted by the lending industry — mean that there will be more information available to lenders about individuals and business owners applying for personal loans. Proponents of CCR contend that this will contribute to:

- loans being set at an interest rate that better reflects the risk of lending to the borrower (in other words, risk reflective pricing will become more common). Debtors that are a low credit risk could experience lower interest rates

Box 7.4 **What is comprehensive credit reporting?**

In December 2012, changes to the *Privacy Act 1998 (Cth)* were passed by the Australian Government. These reforms changed the information that can be contained in credit reports shared between lending institutions. The changes commenced in March 2014.

Prior to these changes, credit reports could only contain 'negative' information — such as instances of default. However, CCR allows credit providers to share five new elements of information about a loan that were prohibited under the old credit reporting system. These elements are the:

- date the account was opened
- credit history of the account
- type of credit
- date the account was closed
- repayment history of up to 24 months.

Banks and other lending institutions are not obliged to share all this information, however, rules in place mean that lenders are only able to access data at the level that they supply data.

The basic rationale behind expanding the information able to be obtained in a credit report is that it will allow for lending institutions to have a more complete picture of the credit worthiness of applicants, allowing more informed decision making from lenders, and better outcomes for borrowers that represent good credit risks.

Source: Johnson (2013); Office of the Australian Information Commissioner (2013)

- a deepening of the market for credit as the effects of information asymmetries are lessened
- greater innovation in lending products
- easier access to credit for subsections of the population that have had difficulty being approved for loans in the past (Johnson 2013; Turner et al. 2012).

If widely adopted, CCR should make it easier for business owners that wish to use personal collateral to secure a loan — such as a private residence — to obtain credit. Further, the fact that under CCR, instances of on time payment — and not just instances of late payment or default — are recorded means that it is likely to be easier for individuals with little (but positive) credit history to receive credit.

The issue of CCR was examined in the Financial System Inquiry Final Report. It noted that:

> Overall, more comprehensive credit reporting would likely improve credit conditions for borrowers, including SMEs. Personal credit history is a major factor in credit providers' decisions to lend to consumers, but also to new business ventures and smaller firms. (The Treasury 2014d, p. 191)

This has been echoed by Deloitte Access Economics (2013a), who suggest that CCR should benefit new businesses:

> While [CCR] may lead to some businesses with poor payment histories to miss out, by reducing uncertainty it should also mean fewer good businesses miss out on finance. Comprehensive credit reporting could be particularly useful for new businesses, with limited financial history to draw on. (p. 15)

Submissions made to this inquiry also supported the introduction of CCR. For example, the Chamber of Commerce and Industry Queensland stated:

> A comprehensive credit reporting regime that provides more frequent and comprehensive data about small business credit history would reduce information imbalances between lenders and creditors, thereby facilitating competition between lenders, improving the way lenders assess risk, and improving credit availability for small businesses. (sub. 8, p. 7)

Similarly, the Australian Chamber of Commerce and Industry submitted:

> ACCI supports the proposal in the FSI Report regarding the creation of a voluntary comprehensive credit sharing regime. By giving lenders ready access to the credit history of potential borrowers, such a framework will address the issue of asymmetrical information between lenders and SMEs. This in turn may lower the cost of borrowing for SMEs. Similar regimes have been very effectively implemented in other OECD economies. (sub. 11, p. 12)

The Commission agrees that CCR would likely facilitate lending to new businesses. The Commission also notes that the benefits of CCR will be greatest if its adoption becomes widespread — if more lenders participate in CCR, more consumer information is shared and more informed decisions about lending will be made.

However, the Financial System Inquiry noted that the voluntary nature of CCR means that the long term participation in CCR remains unknown. This led the review to recommend that the Government should:

> Support industry efforts to expand credit data sharing under the new voluntary comprehensive credit reporting regime. If, over time, participation is inadequate, Government should consider legislating mandatory participation. (The Treasury 2014d, p. 190)

It is possible that the lending industry will move towards adopting CCR without the need for further regulatory involvement. As more and more lenders adopt CCR, those that do not are more likely to experience problems around adverse selection. That said, there are also incentives for some lenders to resist moving towards CCR, particularly large lenders where their volume of customers means the costs of implementing CCR are relatively high, and because they possessed a comparative advantage under the previous credit reporting regime.

It is important to remember that the introduction of CCR is relatively new. The legislation allowing CCR only came into effect in March 2014, and the Financial System Inquiry notes that it may not be until late 2016 or early 2017 before CCR is significantly used. Given this timeframe, the Commission sees merit in a review similar to that proposed in the Financial System Inquiry to examine the degree to which CCR has been embraced by the lending market and whether there is a case for participation to be mandated after assessing the costs and benefits of extending CCR further. This review should be undertaken in 2017.

Should comprehensive credit reporting be extended to business lending?

CCR does not currently apply to business lending, and the Regulation Impact Statement associated with the change did not explore the option of extending CCR to business transactions. However, the issue was examined in the Financial System Inquiry, which concluded that the case for extending reporting to small and medium businesses was not strong:

> Submissions generally argue that the costs of mandatory reporting of SME data would outweigh the benefits. Reporting of SME would impose further compliance costs on credit providers. However, the additional data would not likely reduce information imbalances. This is because the credit health of the business owner(s) as an individual remains the primary information source of credit decisions, rather than information about the SME itself. (The Treasury 2014d, p. 192)

Nevertheless, the Commission believes that a review to examine the case for mandating the use of CCR for personal credit transactions provides an opportunity to at least re-examine the case the business credit transactions be included. By 2017, given that CCR will have been operating for three years, it could be expected that there would be additional information on the probable costs and benefits of extending CCR to business lending, and as such, examination of this issue should be in the remit of the proposed review.

DRAFT RECOMMENDATION 7.1

As identified in the 2014 Financial System Inquiry, the Australian Government should undertake a review of the participation of the lending industry in comprehensive credit reporting in 2017 with a view to determining whether participation should be mandated. The review should also consider extension of reporting to include the comprehensive credit history of businesses.

Is there a role for a credit guarantee scheme?

Credit guarantee schemes (CGSs) can be structured in a number of ways, although most take the form of a public scheme whereby creditors are paid part or all of the value of defaulted loans made to businesses out of government budgets. In return, the government receives part of the return on a performing loan. CGSs are common internationally, although Australia does not have such a scheme.

ACCI (sub. 11), while noting the potential problems with a CGS, proposed that the Government should consider implementing a scheme in Australia:

> The Government should explore the feasibility of a temporary small business loan guarantee scheme. Similar schemes operate in several other international jurisdictions, including the US, UK and Canada, with varying levels of eligibility and coverage. Such a scheme could suffer from 'moral hazard' issues. Further, it could impose contingent liabilities on the Commonwealth's balance sheet. However, a well-designed scheme would avoid the pitfalls associated with any risk-sharing financial scheme by establishing rigorous eligibility criteria and assessment guidelines. If implemented, the scheme could have a sunset provision, preceded by a review date (p. 15)

The issue of credit guarantee schemes has also received attention across a number of recent reports. For example, it has recently been advocated by Deloitte Access Economics (2013a):

> Well-designed and monitored [credit guarantee] schemes can limit the call on public finances. If information asymmetry causes the potential lender to attribute a higher risk of default to a borrower in the absence of adequate security, the credit guarantee can address this. By reducing the loss-given-default with a guarantee, the CGS increases the likelihood of viable businesses gaining access to finance. (p. 44)

The Institute of Public Accountants also supported the trial of a CGS in their *Australian Small Business White Paper* (2014):

> A partial credit guarantee (PCG) fund can assist in alleviating small enterprise financing constraints and expand lending to small firms through reducing lending risk for banks or other financial institutions. A literature survey conducted by the IPA shows that banks see PCG schemes as the most common and most effective government support program for small business lending. A PCG fund can also help diversify risk by guaranteeing loans across different sectors or geographic areas. Moreover, PCG funds bring about the informational gains (as the guarantor has better information about the borrower than the lender). The PCG scheme has been found to deliver gains in employment, business growth and even exports in developed countries such as the UK, Canada and the US. The PCG scheme can be tried and tested on a small scale in Australia (e.g., in one or two states). (p. 24)

Those in favour of a credit guarantee scheme argue that it will improve lending to new or small businesses by:

- reducing the effects of information asymmetries on bank lending decisions, given that banks will be more willing to lend to new and small businesses if they know that part of their investment is covered in the case of default
- overcoming the desire of banks to ration credit by sharing risks between lenders and a third-party (almost always the government)
- reducing the need for business owners to provide collateral to secure a bank loan
- reducing the risk weight attached to small and medium sized enterprise business loans under the Basel III framework. This in turn reduces the amount of capital banks need to

hold to against these loans, which may encourage additional lending (Deloitte Access Economics 2013a).

These factors are often argued to have positive flow on effects on employment or economic growth. Advocates also note that Australia is one of the few developed countries that does not operate a credit guarantee scheme.

Those against a credit guarantee scheme argue that:

- it simply involves a transference of risk from private lending institutions to taxpayers. Further, it may dissuade lending institutions from undertaking sufficient vetting and monitoring processes when making loans, increasing adverse selection and moral hazard problems
- there is often not conclusive evidence that a credit guarantee scheme results in more business loans being made than if the policy was not implemented. In other words, there is not clear additionality or incrementality from introducing a CGS
- the costs of setting up and maintaining a credit guarantee scheme are high. They also represent a significant contingent liability on the public budget that can become large very quickly should many loans default (as might be the case in a severe recession for example)
- despite not having a CGS, Australia's entry rate for new businesses is higher or comparable to many countries that do — for example, Canada, Italy, Spain and the United States. Further information about how Australia's entry rate compares with other economies can be found in chapter 2.

Setting the optimal price of a credit guarantee scheme is also problematic for governments. If the price is too high, the scheme is likely to be weighed down by adverse selection and moral hazard problems as only high-risk applicants self-select into the scheme (lower risk borrowers seek finance elsewhere). Too low a price and there will be a tendency for lower risk businesses (that are capable of sourcing finance outside of the scheme) to select into the scheme. In this case, government has taken on a credit risk and an actual and contingent cost with no additionality in business lending (OECD 2013c). A further complication is the fact that the optimal price that strikes a balance between these outcomes is subject to constant change depending on the interest rates, ease of credit access and overall conditions of the wider economy.

The effectiveness of CGS in increasing the ease of access to debt finance is a subject of much debate within the existing empirical literature. Several studies identify positive effects. For example:

- Craig, Jackson and Thomson (2005) found a statistically significant but economically small relationship between the level of guaranteed lending under the United States CGS in a local banking market and future per capita income growth in that market.
- Riding, Madill and Haines Jr. (2007) found that the Canadian CGS does facilitate lending to SMEs that would not otherwise qualify for loan, with this having flow-on effects to job creation.

- Zecchini and Ventura (2009) found the Italian CGS has been effective in reducing the borrowing costs of SMEs and easing their financing constraints.
- Uesugi, Kaki and Yamashiro (2006) found that the Japanese CGS increased credit allocation to businesses that used the scheme.

However, a number of other studies note that it is very difficult to conclusively prove that CGS do contribute to additional lending to small businesses (for example, (Green 2003; O'Bryan III 2010; De Rugy 2007). Empirical work examining the effects of CGS on business survivability is also inconclusive — for example, Oh et al.(2008) found that businesses supported under the Korean CGS did experience significantly higher survival rates, however this contrasts to research by Uesugi, Sakai and Yamashiro (2010), that found that participants in the Japanese scheme were significantly more likely to experience financial distress than businesses that did not part of the program.

Studies have also examined whether CGS distorts the credit market — for example, Cowan, Drexler and Alvaro (2012) find that CGS reduce the effort exerted by banks in collecting loans, which has marked effects on the proportion of loans that can be considered to be delinquent (behind in repayments by more than 60 days). As CGS typically see defaulted loans repaid at least in part by governments, the cost of these delinquent loans is partially borne by taxpayers. Green (2003) suggests that schemes available for loans made to small businesses may see an undesirable substitution of credit away from large (uncovered) borrowers towards small (insured) borrowers. The possibility of distortions is also acknowledged by Honohan (2010) who notes:

> Even if fiscal costs are low, the economic costs of misallocated resources can be high. While it is clear that public interventions into the credit market will tend to have distorting incentive effects, these distortions are subtly different depending on the type of scheme, for example, resulting in too much entry, too much risk, too little monitoring or entrepreneurial effort or in rent-seeking behaviour. (pp. 6–7)

The Commission examined public guarantee schemes in 2014 as part of its inquiry into public infrastructure and found that 'the use of guarantees entails several risks and costs for the government and taxpayers' (PC 2014d, p. 236), noting that such schemes place contingent liabilities on government balance sheets (that then puts pressure on credit ratings), act as a source of moral hazard risk, distort financing decisions and are often not transparent. In addition to these reasons, the Commission does not support the introduction of a CGS for business lending because:

- as flagged in chapter 5, problems accessing finance for new businesses are not widespread. Most new business do not seek finance beyond the personal resources of the business owner, and of those that do, the majority seem to be able to access external funding. The lack of systemic financing problems for new businesses weakens the case that Australia needs a CGS.
- as discussed above, there is not conclusive evidence that CGS results in positive long term outcomes. Studies have not shown conclusive evidence that CGS materially increases the amount of lending to new or small businesses and even among studies

that do find that CGS yield positive effects on loan formation, these effects are often small, and usually caveated with warnings that measuring additionality is difficult. Findings on whether participation in a CGS translates to higher rates of business survival are equally as mixed, and the costs of economic distortions can be high.

DRAFT FINDING 7.1

Credit Guarantee Schemes are not an efficient way to improve access to debt finance for new businesses.

Is there a role for concessional lending by governments?

One policy lever governments have used in Australia and overseas to influence new business formation is offering loans at reduced interest rates. A subset of these programs in Australia is summarised in box 7.5.

Box 7.5 Examples of concessional lending

- **First Start Loans** is a **Queensland Government** program that provides concessional loans to assist with the establishment of primary production or fishing businesses. Applicants can apply for a loan of up to $650 000 for a period of up to 20 years at fixed interest rates. As of 5 January 2015, these interest rates ranged from 3.72 to 3.88 per cent per annum. Applications are assessed against an eligibility criteria that includes an assessment of the viability prospects of the business.
- The **Business Development and Assistance Program** is an **Australian Government** program that provides loans at a discounted interest rates to Aboriginal and Torres Strait Islander people to establish, acquire and grow a viable small business.
- The **ACT Microcredit Loan Program** is an **ACT Government** program that provides interest free loans (up to $3000) or low interest loans (up to $10 000) to low income earners who want to start or expand a business.
- The **No Interest Micro-Business Loans** is a similar program operated by the **Tasmanian Government** that provides interest free loans to low income earners of up to $3000 to start or grow a business.
- The **Regions Loan Scheme** is a **South Australian Government** program that can be used to finance new market development or expansion in non-metropolitan areas of South Australia. For funding sourced from the initial funding pool (of $4 million), the rate of interest is fixed at 3 per cent.

Source: ACT Microcredit Program (2014); Government of South Australia (2014); Indigenous Business Australia (2015); Queensland Government (2015b); Tasmanian Government (2013)

The Commission has examined issues around concessional loans, most recently in its inquiries into Public Infrastructure (2014d) and Australia’s Export Credit Arrangements

(2012c). Both these studies identified risks associated with concessional loan programs (box 7.6).

Box 7.6 Previous Commission findings around concessional loans

In *Australia 's Export Credit Arrangements,* the Commission stated:

> … governments have sometimes intervened to correct perceived financial market failures by providing finance for what they saw as commercially viable projects rejected by the private sector. However, governments are not necessarily as well placed as the private sector in assessing and pricing risk or allocating credit. They are not subject to the same level of scrutiny as private sector providers that have to account to their shareholders for their decisions. Nor do they face the same consequences as the private sector from poor judgements. (p. 112)

In *Public Infrastructure*, the Commission stated:

> [Government loans] may give the government less flexibility to withdraw from a poorly performing investment. The adverse balance sheet consequences from writing off a bad loan could create an incentive for the government to "throw good money after bad" and continue supporting a failing investment when it is not economically efficient to do so. (p. 228)

Source: PC (2012c, 2014d)

The Commission has also identified that assistance towards particular industries or regions — as some of these subsidised loan programs do — risks generating a welfare loss for the community. For example, with respect to farming, the Commission noted in its submission to the Agricultural Competitiveness Taskforce:

> Sectoral assistance, for example, distorts market signals and provides an incentive for uncompetitive farms to remain in operation. It will also impede more efficient farm businesses from expanding their operations by acquiring land to capture economies of scale. (PC 2014f, p. 8)

On the issue of regional assistance, in its 2014 *Trade and Assistance Review*, the Commission stated:

> This preferential treatment comes at a cost to other businesses — those outside the scope of the measure — that may be competing for scarce labour and capital resources, and to businesses and households that may have to pay higher taxes or other government charges to fund the preferential treatment …
>
> Measures that seek to "force development" in situations not matched by an underlying potential competitive or comparative advantage, or where there are no clear regulatory or technical impediments to growth, have a heightened risk of imposing net costs on the community. (PC 2014g, p. 51)

Other loan programs are tied to broader social objectives, such as improving the welfare of low income and Aboriginal and Torres Strait Islander individuals and for some governments, these form part of their policy portfolio to address social disadvantage. These programs may have the potential to be an effective and efficient means of assistance, particularly if the alternative to setting up a new business is to receive welfare assistance.

However, for policymakers the challenge is to ensure such programs remain targeted and consistently deliver net social and economic benefits.

It is important that there is publically available information about the rationale and objectives that define the loan program's purpose and scope. If the purpose of the program is to address disadvantage, then this should be explicit. Having clear objectives not only helps to ensure a program is targeted, but also provides a criteria against which performance can be assessed.

The program should be able to identify and demonstrate the lending market failure that warrants governments providing these concessional loans. A rigorous process should be implemented to assess the viability of a business applying for these loans, with only businesses that are realistically likely to be viable over the medium to long-term supported. Supporting businesses that are not viable (without continued government support) reduces community welfare.

Finally, programs should be regularly reviewed against their objectives to evaluate whether the program is meeting its goals and delivering net social and economic benefits for the wider community. These reviews should be undertaken independently, be evidence based and be made publicly available. Programs that fail to deliver clear and persistent net benefits should cease.

The Commission maintains that the best way to encourage new business formation is to develop and maintain a regulatory and economic environment that supports new businesses.

DRAFT RECOMMENDATION 7.2

Unless clear and persistent economy-wide net social and economic benefits can be demonstrated, governments should cease to offer concessional loans to individuals seeking to start a business. Government programs for concessional loans to new businesses on the basis of their location or their industry should be ended.

7.4 In summary

There is no doubt some new businesses do struggle to access debt. Others are able to obtain it, but through products (such as credit cards) that have a relatively high cost compared to secured business loans. This, in itself, is not evidence that new businesses face systemic issues accessing debt finance in Australia.

Banks provide the bulk of business lending in Australia, and often the only form of debt new business owners can obtain from banks is a credit card. The interest rate for credit cards far exceeds the rate for secured business loans, and this can be viewed as a funding gap, but this in itself does not support the need for government action. P2P lending is starting to fill this space, but so far, only in a small way.

On balance, the Commission can see no major regulatory impediments that impact negatively on the ability of new businesses to obtain debt finance in Australia. The challenge for governments is to ensure that future regulation is not unnecessarily burdensome, is conducive to competition and is technologically neutral. This way, existing gaps in the debt market can be filled by future entrants that see opportunities for profitable lending.

DRAFT FINDING 7.2

While some new businesses are unable to obtain debt financing, there is no evidence to suggest that there are regulatory impediments restricting the ability of new businesses to access debt in Australia that require a policy response.

That some businesses rely on credit cards as a significant source of debt finance can be viewed as evidence of a funding gap. However, the existence of a gap in the traditional financing market does *not* in itself indicate a need for government involvement and new lending models, such as peer-to-peer lending, represent innovations that could go some way to filling the gap.

8 New business models, the digital economy and regulation

Key points

- With lifestyle and demographic changes, consumers are increasingly seeking new and innovative products and services or the same products and services delivered in new ways. Consumers have embraced the Internet and the new products and services offered by businesses operating in the digital economy, such as Internet shopping and platforms that facilitate online marketplaces.
- Innovative new business models offer wide ranging benefits. Consumers benefit from lower prices and a wider variety of products and services delivered with greater ease and convenience. For new business models, innovation provides a source of high growth in income and business value. There are also economy-wide benefits with better application of information and more efficient use of underutilised assets and skills, as well as providing an alternative source of income to some households.
- Most new business models fit within existing regulatory requirements. For those new businesses that operate in regulatory grey areas, the main concerns raised relate to ensuring consumer safety and protection, public amenity, taxation and inequitable treatment of incumbents. These concerns are often voiced by incumbent businesses or their representatives.
- Governments and regulators have a number of solutions available to encourage businesses to innovate and offer products that benefit consumers and the wider economy, while proportionately managing the apparent risk to the community.
  - Regulators need to maintain a flexible approach to enforcement. All jurisdictions should provide a framework for granting fixed term exemptions to regulatory requirements that provide barriers to entry or business growth. Regulators should have the capacity to place conditions on the exemption to protect consumers, public health and safety, and environmental outcomes. Such exemptions should be disallowable instruments. Regulators should not aim to protect incumbent businesses from competition.
  - Governments should have rolling reviews of regulation to assess whether the objectives and design are still effective. Regulatory reviews provide an opportunity to clarify regulatory arrangements for new business models, while at the same time reducing unnecessary burdens on incumbents businesses.

This chapter examines business models in the digital economy, the benefits and costs to consumers, business and the economy, the regulatory challenges that some new business models have raised and the solutions available to government to capture the broader benefits of these new growth businesses while managing the risks to society.

8.1 Rapid changes in the way businesses operate

The term 'business model' describes how a business creates, delivers and captures value to generate profits for the business and a source of earnings for the owners. Core elements of a business model include the purpose of a business, customer profile, marketing and advertising approach, distribution channels, revenue sources and organisational structure.

New business model approaches look for innovative ways to create value and generate profits. Recent examples include the sale of goods and services online instead of physical stores, the introduction of electronic books in competition with paperbound books or the move from general advertising in print media to personalised advertising based on customer information gathered from previous sales or past Internet searches.

Businesses have used technological advances to change their business model for many years, even centuries. The common element is that technology changes the way value is created as well as, at times, causing some uncertainty and unease among industry competitors and the broader community, particularly when changes are large. Examples include the first industrial revolution that mechanised the textile industry, McDonald's restaurants streamlining their menu and food assembly process in the 1950s to current changes based on information technology.

However, what is genuinely new about the current wave of transformative business models is that the superior collection, analysis and application of information has enable new and better ways of doing business. This new wave of business models has been facilitated by information technology — enabled by easy and low cost Internet access through the rapid growth of smart phone and tablet ownership and app development. For example, Netflix — an on-demand Internet streaming provider — creates its original programming schedule based on its customers' viewing habits and Hubway, a bike sharing system in Boston, tracks millions of its customers' rides to optimize the availability of bikes at its stations (Lee Yohn 2015).

With changing consumer preferences and economic and regulatory reforms, markets have also become more competitive. In more competitive markets, businesses are motivated to innovate as those that are slow to respond to changing consumer preferences lose market share to competitors. This competitive discipline is reinforced by greater diversity among consumers who are better educated, have more access to product information through the Internet and expect a wider range of products and services (box 8.1).

Box 8.1 Selected examples of new business models and digital innovation

Digital stores

Shoes of Prey is an Australian online retail store where customers design their own shoes — choosing the shape, colour and heel height using a 3D design tool. This business model taps into the consumer desire to find the perfect shoe by providing a made to order product that challenges other models of shoe production and sales. The online business has also opened concession stores within large retailers to help customers design shoes, overcoming consumer concerns that may pose as barriers to ordering entirely online.

Peer-to-peer platforms — connecting buyers and sellers of services

99designs is an online graphic design marketplace, sourcing business design options (such as logos, website, and packaging) through a 'design contest'. Businesses (contest holders) write a brief on the type of design required, including the contest cash prize. Designers from around the world compete for the prize by submitting designs and the contest holder gives feedback. There are a number of qualifying rounds before the contest holder selects a winning design. 99designs' business model challenges traditional graphic design businesses as it relies on designers presenting complete design work with only a possibility of payment. For some, it provides an opportunity to compete for work in a larger market potentially establishing a reputation and career sooner. However, it has been criticised as designers provide original finalised designs without payment.

Sharing of assets – collaborative consumption of assets

Uber is a mobile-app based ridesharing platform that links customers wanting transport with drivers for a fee. The platform allows people over 21 years old, with a full driver's licence and a car (there are limits on the age of the car) to offer rides to people requesting the service. Once requested, the customers can track their 'ride' via a mobile phone app. As payment is made through prearranged processes, no cash or card transactions occur at the end of the service. This business model challenges traditional taxi and hire car businesses, claiming to offer better quality and more streamlined services, generally at a lower price.

Airbnb is a website that connects people with accommodation to let (hosts) with people seeking somewhere to stay (guests). Airbnb facilitates the connections but does not own any accommodation. Accommodation types range from entire apartments and houses, or a private room in one of these dwellings to having accommodation in a host's lounge room or other shared space. This model differs from traditional accommodation where the business has purpose built premises, such as motels. It is similar, in some instances, to coast holiday letting but on a global scale and in non-traditional locations, such as large cities. While some traditional accommodation businesses are using Airbnb as a marketing platform, the new business model has expanded the market with people offering their primary residence when they are away or to share. Consumers are attracted to the variety of accommodation on offer, the affordable prices available as well as the intangible benefits of having a more authentic travel experience and making connections with locals. New business models are emerging around Airbnb with people building their own business to advise Airbnb hosts how to improve their listing, develop a pricing strategy and write locality guides (such as Guest Ready).

Source: Mitchell (2014); Lacy (2012); Uber (2014b); Doherty (2015); Lott (2014); Willmer and Nagy (2014)

While all successful new business models have tended to alter the nature of existing business operations both within and across industries, some new business models based on digital technology have led to changes that occur at a pace and magnitude that transform established ways of doing business (Riemer 2013). This is known as digital disruption. New business models that disrupt are not merely the digitisation of an existing business. Rather, they challenge and change the traditional expectations of producing or consuming goods and services. For example, the development of the smart phone has changed the nature of a mobile phone from a phone to make calls to communicate to a small computer with numerous communication tools, among other functions (Capgemini 2015).

One new business model embracing digital technology is the digital intermediary that uses a sharing or peer-to-peer model. (Other examples are outlined in Capgemini (2015)). The central element of a sharing or peer-to-peer model is an intermediary business with a platform (website) that brings together sellers of products or services with consumers of these products or services. The intermediary business acts as a facilitator receiving a fee for the facilitation service rather than directly producing goods or supplying services for sale. These new business models are based on access to, rather than ownership of, assets (both physical and skills) and are often low cost, high frequency trades. In the past, high transaction costs meant that such trades were not worthwhile. That is, it would simply be too difficult and take too long to find a person who had, for example, an underutilised house or car, that they were prepared to hire out to an unfamiliar person. It is the take-up of digital technology that has enabled these new business models to emerge, along with changing consumer preferences and economic pressures (such as the global financial crisis). Social media and in-built reputational rating systems are an essential element of the digital intermediary business model as they provide a method for consumers and sellers to build trust and reputation (Slee 2013). Collectively these businesses form the sharing economy — also known as peer-to-peer economy or collaborative consumption economy.

Benefits, costs and challenges of digital business models

For business

New business models present both opportunities and threats for businesses. On the one hand, they offer new opportunities for the creation of a high growth innovative business for entrepreneurs to compete with established businesses in a variety of industries. On the other, the changes that occur in the market can happen at a pace and scale that impacts on existing business practice, threatening and invalidating existing business models. Existing businesses often need to:

- adapt (such as a department store offering a variety of channels for customers to research and shop — physical and online stores — to provide a seamless shopping experience)
- restructure by moving out of a line of business in some markets (for example, through Kodak’s business restructure it ceased making digital cameras)

- cease operating (such as the decline in retail DVD rental stores).

Businesses that adapt and restructure — in the face of technological advances and innovative practices introduced by new businesses models — may also in turn become more innovative and productive. The spillover of knowledge is a recognised catalyst of innovation, adaption and invention (Harper et al. 2015).

For consumers

Innovative new business models also offer benefits to consumers. The increased competition provides greater access to and choice of products and services, increased convenience of consumption and lower prices. It may enable a larger range of customers (of different geographical areas and income levels) to consume the products and services. US-based research found that below-median income consumers enjoy a disproportionate share of the welfare gains from the sharing economy (Fraiberger and Sundararajan 2015).

Utilisation of assets

Some new business models offer broader economic benefits from better utilisation of existing resources. As noted above, digital intermediary businesses match people that own underutilised assets with people wanting to rent these items for short periods (that is, weekend use of a power tool or use of a car for 2 hours). Many of these assets lay idle for considerable periods of time. For example, the Grattan Institute (2015) estimate that there are around 11.5 million spare bedrooms in Australian households, representing about $5 billion of forgone income, if these rooms were rented out for around two weeks per year.

The benefits of better utilisation of assets have the potential to be significant as they likely to occur on a large scale. While people have shared and borrowed from family, friends and neighbours for many years (based on trust developed over time), digital intermediary business models have expanded this network pool beyond a group of known people in a limited geographical area to a wider group potentially drawn from all over the world (for a fee). Internet marketplaces that assist the sale of second hand goods, such as Ebay and Gumtree, for example, are digital versions of second hand shops or notice boards. They connect many more, often globally, dispersed sellers and buyers, leading to a much more efficient use of goods (Olma 2014).

With Internet platforms creating an economic market for 'spare capacity', some households are earning extra income — sometimes these households are 'assets rich and income poor'. The additional income received can assist people financially when they have lost their job or during a martial breakdown, for example. At an individual level, by renting out a room on Airbnb, for example, a Sydney woman was able to meet her mortgage repayments following a divorce (Leigh 2015).

8.2 Digital business models present regulatory challenges

Most new business models fit within existing regulatory requirements. However, some offer products and services that operate, or may induce other businesses to operate in regulatory grey areas. New technologies and businesses sometimes do not fit within the existing regulations — either because certain actions are in contravention of the intended purpose of regulations or were simply not considered at the time of drafting. Regulatory barriers to new business models are not new or restricted to the digital economy (box 8.2).

Box 8.2 **Regulatory barriers to entry and growth for new business models in the non-digital economy**

Food trucks

Food trucks — with a change in business model — are enjoying a resurgence in popularity. Contemporary food trucks offer a wider range of higher quality foods for sale than previously at affordable prices (such as wood fired pizza, slow cooked roasts, Vietnamese baguettes, curries, gourmet hot dogs, desserts and barista coffee). Food trucks move around to different city locations over the course of a week, often assembling together near parks. Consumers have embraced the new model with people travelling to their favourite truck after its location is posted on social media.

In some situations, local councils have placed restrictions on these vans. The City of Maribyrnong in Melbourne, for example, has restricted the number of food trucks to 10 at the Yarraville Gardens — when previously this location attracted up to 18 food vendors. Council restrictions came after complaints of dirty and broken toilets, excess rubbish, and claims of illegal dumping of cooking oils. Food van proprietors argue they are unfairly restricted when the council is failing to provide sufficient infrastructure, such a bins or not emptying bins regularly.

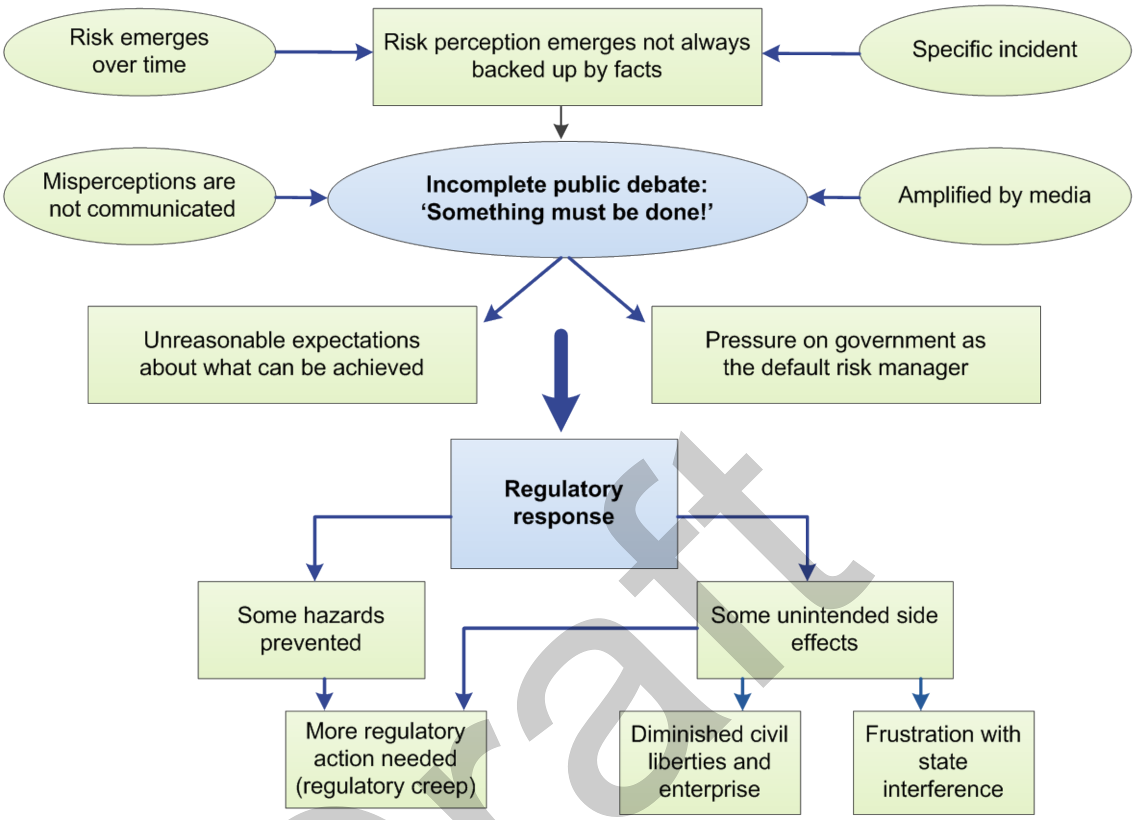
Zero-waste café

A zero-waste café in Melbourne — serving soup that uses by-products of high-end restaurants such as unused meat and seafood bones — encountered regulatory difficulties with the location of its compost machine. As a condition of the planning permit, the council required the café to accept liability for the compost machine located in a laneway, paying a fee of $12 500. The café owner claimed that the business should not have to pay the fee as there are spillover benefits from the operation of a zero-waste business, including saving the council from not collecting rubbish.

Source: Wu (2014); Worrall (2015)

Governments and regulators face ongoing challenges of applying existing regulatory frameworks to new business models with differentiated products and services in a rapidly changing environment. They face pressure from many groups (businesses — both regulated and unregulated, other governments and politicians, media and the broader community) to take action — potentially leading to poor outcomes (figure 8.1).

Figure 8.1 **Regulatory pressures to respond to risk**



Source: Based on Better Regulation Commission (UK) (2006)

This section outlines the concerns that have been raised in the course of this inquiry using two intermediary digital platform businesses — Uber and Airbnb — as case studies. These concerns are illustrative of the range of issues that can arise. Governments and regulators need to weigh up and assess the costs and benefits of such new business models, on a case by case basis.

Consumer protection — ridesharing case study

Quality and safety concerns

One criticism of new business models is that when they offer new products or services that fall outside traditional regulatory boundaries, consumers may not be protected by the consumer policy regulatory framework (box 8.3). For example, the mobile-app based ridesharing platform, Uber — that links customer's demand for transport with available drivers for a fee — claims its business model falls outside industry specific taxi regulatory requirements as it does not provide taxi services. For example, Uber notes how it differs to a taxi service:

> While ridesharing competes with the taxi industry, ridesharing is not a taxi service … . Notably, ridesharing trips … are not anonymous, cannot be hailed on the street, do not use taxi ranks and do not have taximeters (Uber 2014a, p. 1).

Box 8.3 **Consumer safeguards**

The Australian Consumer Law provides a broad framework for how all Australian businesses will deal with consumers. It is designed to enhance market outcomes by:

- protecting consumers from unconscionable or deceptive conduct, and from unsafe or defective goods and services
- providing consumers with remedies when they suffer loss from such conduct or products
- assisting consumers in making better purchasing decisions by providing product information.

Beyond this, there are a range of industry specific regulations in place that provide further protection when it is considered to be difficult for a consumer to assess the attributes of a particular product or service prior to purchasing or the risk of detriment to the consumer is high. For example, food safety regulation aims to provide consumers with an assurance that food purchased will be safe to eat as the safety of food cannot always determined from consumer observations and the consequences of eating unsafe food can be high.

Source: PC (2008d)

But ridesharing services, on face value, are similar to taxi services in that they seek to meet the demand of passengers to travel by car between two points. They are not, however, complying with taxi regulations that aim to ensure the quality of service and safety of passengers (except in Victoria where Uber's ridesharing services comply with driver accreditation laws). This has raised concerns by some, including incumbent industry players, that consumer protections are compromised. The regulatory response domestically and internationally to Uber's operations has varied from accommodating to prohibiting (box 8.4).

However, there are a number of mitigating factors that may mean the lack of industry specific consumer protection is not as much of a concern or pose large risks to all consumer groups as on 'first glance'.

First, digital intermediary businesses models generally have design features that reduce information asymmetries between the business and customer, providing some consumer safeguards and decreasing the inherent associated risks that regulations are also attempting to overcome. These platform businesses have quality information embedded into the products and services on offer through a rating system. For example, when a customer requests an Uber driver to take them to a particular location, they receive rating information on the driver from previous customers, as well as the cost of the service and the estimated waiting time before a driver arrives. Customers rate drivers on factors such as the cleanliness of the car, the behaviour of the driver and the driver's knowledge of the roads. Drivers also have the ability to rate customers, providing drivers with a 'right of reply' and a balancing influence against customers providing vindictive or inaccurate ratings. The two-way system appears to be an effective means for informing customers of the quality and safety when the service offered is based on repeat business — thereby building a system of reputation and trust like many existing businesses.

Box 8.4 Regulatory responses to ridesharing

Australia

Uber ridesharing is currently operating in six Australian cities: Brisbane, Gold Coast, Melbourne, Geelong, Perth and Sydney. State governments, that are responsible for regulating transport, have indicated that ridesharing operations offer by Uber is illegal. A number of jurisdictions have issued cease and desist notices and/or issued fines to ridesharing drivers. Since late 2014, Uber has agreed to comply with driver accreditation laws in Victoria.

Europe

In April 2014, Uber's ridesharing service was banned in Brussels after taxi companies took the company to court arguing it failed to comply with local taxi regulations. And in other parts of Europe, Uber is facing restrictions on multiple fronts: it has been ordered to shut down operations in Madrid by a Spanish judge; its ride-sharing service has been banned by a court in the Netherlands; it has also been given injunctions in Germany; and drivers of its cars are being fined and having their vehicles impounded in Italy.

USA

In the United States of America, a number of cities and states (for example, Minneapolis, California, Seattle, Washington D.C, Houston, Colorado) have amended regulations to license ridesharing activities, with drivers requiring background checks and cars undergoing inspections. In doing so, regulators have debated the merits of which party should hold licences (the Internet platform or drivers), whether there should be caps on the number of licences in total or per company and whether pricing control should be introduced.

Source: Uber (2014c); Taxi Services Commission (2015); Lomas (2014)

Second, competition also provides an incentive for new market entrants to deliver a product or service that is of a quality that meets consumer expectations — otherwise they are unlikely to be a credible competitor and to successfully remain in the market. Most businesses have company policies and standards to underpin their product or service and their market reputation. Uber, for example, requires drivers to be at least 21 years old with a full drivers licence, have background checks and own a registered and insured four-door vehicle manufactured after 2006 (Uber 2014b). With consumer preferences changing, it is likely competitive pressures will reflect expectations of minimum acceptable quality more responsively than government regulations.

There will, however, be times when competitive pressures will not be sufficient to prevent consumers receiving a service or product that is unsafe or of lower quality than expected and nor will the rating system be sufficient recourse. However, consumers needing access to remedies for deceptive conduct, and from unsafe or defective goods and services is not unique to new business models. Problems and issues also occur with traditional products and services. For example, the Taxi Service Commission in Victoria issued almost 6000 notices to industry participants for breaches of regulations in 2013-14 (Taxi Services Commission 2014). At times, media reports can highlight individual examples of 'things going wrong'. The concern in this situation is governments taking a short-term reactive approach by banning or heavily restricting new and innovative products and services without fully assessing the costs and benefits of allowing new businesses to operate, perhaps within a modified regulatory system for all businesses.

Pricing concerns

Some new business models use technology that enables them to be more adept at price discrimination than existing businesses and charge variable and sometimes high prices for products and services. This has led to criticisms of price gouging and taking advantage of consumers by charging 'unacceptably' high prices. Uber, for example, uses dynamic pricing strategies (that it calls 'surge pricing') that increases prices in peak demand periods (relative to supply) and lowers prices during off-peak periods (box 8.5).

Box 8.5 **What is dynamic pricing?**

Dynamic pricing is a strategy that allows prices to vary depending on the time, number of customers, number of suppliers and other factors. In times of peak demand and constraints on supply, prices rise. One of the benefits of dynamic pricing is a better allocation of resources: to an activity that has greatest marginal benefit and to consumers who most value the product or service.

Dynamic pricing is not new and is used in industries such as travel (airline tickets prices), hospitality (accommodation prices), transport (road tolls) and entertainment (movie ticket prices), among others. It is also used in a number of new business models such as online retailing but most notably by Uber.

Uber's surge pricing system automatically detects situations of high demand and low supply and increases the price in increments (usually a multiple of the standard price, depending on the extent of the shortage). The aim of surge pricing in the rideshare market — where barriers to entry are low and elasticity of supply is reasonably high — is to encourage more drivers into the market at high demand times, with supply increasing and the fares for services declining accordingly. This provides incentives for drivers to drive at peak times for a suitable level of compensation. Demand surges are also monitored by Uber, who have on occasions used their discretion to lower prices.

Source: Kedmey (2015)

Under this pricing strategy some consumers have been 'caught out' with high fares at peak times and often not knowing until after the 'ride', as final payment is made through an automatic prearranged process. Surprise and shock over the cost of a product or service is not unique to ridesharing with some consumers in other industries having similar experiences (although not always as a result of dynamic pricing), such as the cost of airport car parking or mobile phone bills particularly after international use. 'Sticker shock' is more likely to occur when a service has been provided and payment occurs afterwards.

While the Commission does not support businesses raising prices because of misuse of market power, high prices per se or consumers being surprised at the total cost are not reasons to introduce price controls (and thereby lower the efficiency of the market).

Instead, market based information systems can provide better outcomes. Businesses, both new and incumbent, should inform consumers of the price of services — reflecting the cost of service provision, amenity afforded to the consumer, intensity of competition and the extent of demand — prior to accepting the product or service. For example, consumers are informed of surge pricing practices used by Uber as a condition of use and are notified when higher price periods apply prior to requesting a driver. Uber also undertook an information campaign prior to New Year's eve to let customers know that prices were expected to be higher during certain times and providing suggested ways to avoid the peak pricing (Singhal 2015).

Despite the actions of some governments internationally, the Commission considers that price controls are not necessary, even in the face of an unusual event, so long as businesses continue to inform customers of the cost of service prior to accepting. Some governments have limited the use of dynamic pricing in emergencies and extreme weather events. For example, in the event of a snow storm in New York city, the maximum surge pricing multiple is capped at the fourth highest multiple applied in the 60 days prior to the snow storm (Holmes 2015). Apart from the inefficient nature of these price controls and the cost of enforcing such arrangements, they are not considered necessary as damage to the business' reputation — that usually results in consumers using competitors in the future — will generally be sufficient to prevent prices increasing excessively at unplanned times on repeated occasions. Furthermore, it is not unreasonable to expect that there are times when fewer operators are willing to provide a service or more consumers are willing to pay higher prices for a service.

Public amenity — the short-term rental market case study

New business models can also challenge existing regulatory frameworks that are designed to ensure businesses operate in ways that provide a certain level of public amenity of the local area. For example, the introduction of new businesses facilitating short-term rental (such as Airbnb and Stayz.com.au) has led to an increase in the number of residential dwellings being used for this purpose. While there can be a number of benefits of this for local communities, concerns about negative spillover effects on residents have included:

- excessive noise from properties
- risk to public safety, especially in relation to violence against women
- inappropriate disposal of rubbish

- traffic and parking congestion
- loss of sense of community and connectedness.

The regulatory arrangements of short-term rental are regulated by local governments and, consequently, are varied and mixed. One fundamental problem sometimes encountered is whether or not short-term rentals are permitted. Some local governments do allow for 'holiday lets' if it is for a short-term, limited to no more than a certain number of people and does not interfere with the amenity of the neighbourhood. The Blue Mountains City Council, which provides a good example of outcome based regulation, permits holiday lets without consent in a dwelling provided that:

> … the use is only short-term, does not involve more than 8 overnight guests per dwelling and does not interfere generally with the amenity of the neighbourhood in any way, including noise or traffic generation (Blue Mountains City Council 2013, p. 2).

Other local governments have no arrangements for short-term letting and have chosen to impose fines on property owners that are renting out rooms on a short-term basis — often responding to complaints made by neighbours. It has been reported that Randwick City Council, for example, issued warnings of potential $1 million fines — the penalty for a breach of the planning controls for an unauthorised bed and breakfast (McKenny 2014). Regulatory best practice usually applies an escalation model to enforcement where regulators start with an educative approach and apply tougher sanctions whenever lower levels of intervention fail to secure compliance (PC 2013e).

A number of state and territory governments are examining these regulatory issues. In Victoria, a panel has been appointed to review the issues, including the impact of short-term rental in city apartment buildings, and to make recommendations to government by mid-2015 (Consumer Affairs Victoria 2015). In Queensland, a government review in this area has been focused on minimising the negative flow on effects of houses and apartments let primarily for large parties in coastal areas such as the Gold Coast (Hemsley 2014). In New South Wales, there have been calls from both local government and industry for the state governments to develop a planning and approval process for holiday letting to provide certainty to operators and a framework for local government use (Legislative Council (NSW)(2014).

The Commission considers that the priority for governments in dealing with new business models such as Airbnb should be to manage the apparent costs and benefits to the community from short-term letting rather than protecting incumbent businesses from competition. In the context of Airbnb, for example, this would mean regulating for congestion, noise levels and consumer protection in the same way that these issues are regulated more generally. Governments should also ensure there is a timely, transparent and effective avenue for handling community complaints.

Some consideration may also need to be given to the additional public safety issues that could arise with property rental. In particular, where dwellings have been approved to accommodate a certain number of people for fire safety reasons, governments could consider some simple criteria to ensure public safety objectives are maintained. For example, some local governments have limits on the number of people per dwelling based on the number of bedrooms.

The Commission, however, recognises that planning, zoning and development assessment laws and processes are complex with many (sometimes competing) objectives. There is a growing body of evidence that holistic reform in planning, zoning and development assessment is necessary — not just in the area of short-term rental accommodation (Harper et al. 2015; PC 2014e; PC 2011d). This reform should be a priority for state, territory and local governments (section 8.3).

Inconsistent treatment of incumbents and new entrants

Regulation aims to provide net benefits to the community by generally requiring businesses to undertake certain actions (chapter 3 outlines regulatory requirements of starting and operating a business). These regulatory obligations impose costs on incumbent businesses that comply with requirements. These costs are then passed on to consumers in higher prices.

In highly regulated industries, incumbent businesses have complained that new innovative business models are operating outside the regulatory framework with an unfair advantage as they do not have to incur the cost of regulatory obligations. The Accommodation Association of Australia stated that tourism accommodation infrastructure (both new buildings and renovating existing buildings) can take a minimum of six years to develop from concept to completion due to the cost and complexity of approvals processes and other government regulatory requirements (sub. 25). Amongst other conditions, approved tourist operators have to satisfy sector-specific regulatory requirements on aspects such as: operating hours, fire safety, disability access, traffic access, parking, public access safety and food safety.

The Commission considers that businesses operating in a similar manner with similar risks to the community should be governed by the same regulatory requirements. Nevertheless, it is not clear that some new business models have the same level of risks to manage as some incumbent businesses. For example, some properties available to rent on websites such as Airbnb are domestic dwellings — which the hosts sometimes live in — more akin to coastal holiday letting or bed and breakfast accommodation than large motel or hostel accommodation. When considering the regulatory response to new business models, governments should assess the perceived risk level of the new business as well as reassessing the need to retain all the current regulatory requirements for existing businesses in order to achieve the desired outcomes for the community. Claims by incumbent businesses to maintain the current level of regulation for all businesses should be carefully assessed to ensure that the regulatory framework is not being used as a barrier to prevent competition that would benefit consumers and the broader economy.

INFORMATION REQUEST

Are there valid circumstances for compensating incumbent businesses affected by regulatory changes that accommodate new business models? If so, what are they?

Taxation issues of new business models

As the digital economy grows, governments and communities have become increasingly concerned with the potential loss of tax revenue including:

- the possible lack of collection of GST by suppliers in the sharing economy
- the exemption of GST collection on low value imports
- potentially undeclared income from individuals generating income by renting underutilised assets, such as cars or spare bedrooms or supplying their labour.

In general, taxation should be applied in the same manner for similar activities to minimise distortions in resource allocation in the economy. However, exemptions do sometimes apply, including some businesses being exempt from registering and/or collecting GST (box 8.6). Furthermore, the Australian Taxation Office provides guidelines for declaring income, including the renting of a primary residence and has a range of tools to ensure declaration of income more generally (Australian Taxation Office 2014).

Box 8.6 **Registration for GST and exemptions**

As outlined in chapter 3, most businesses will register with the Australian Taxation Office for the purpose of GST collection. Businesses with a turnover below $75 000 are not required to register and collect GST with the exception of businesses that provide taxi travel and those that want to claim fuel tax credits. Small businesses are provided with this exemption because the compliance costs associated with applying and collecting the GST for a low level of turnover would outweigh the benefit of collecting the tax revenue. The Commission estimated that 18 per cent of businesses are below the turnover threshold and are not registered for GST (chapter 2).

Similarly, low value imports (less than $1000) are mostly exempt from GST, customs duty, fees and charges, and the requirement to complete a full import declaration — as the cost of collection associated within the current parcel and cargo handling process would cost more than the additional tax revenue collected.

Source: PC (2011c); Australian Taxation Office (2015b)

As some suppliers in the sharing economy will have sales below the GST collection threshold, they will not need to charge and collect GST. While taxi and hire car businesses need to register for GST regardless of their turnover, ridesharing businesses remain in the regulatory grey area.

With regards to low value imports, the Commission has previously found that a lower GST threshold for imported goods would bring with it a net cost to the community (PC 2011c). While a subsequent taskforce also found lowering the threshold would not be worthwhile, other research commissioned by stakeholders suggests that there are alternative arrangements for collecting GST on low value imported goods that would not be as costly as current arrangements (Australian Government 2012b; The Treasury 2015b). In the 2015-16 budget, the Australian government announced plans to extend GST to cross border supplies of digital products and services imported by consumers from 1 July 2017 (Australian Government 2015a).

These tax issues have also been identified in the discussion paper that pre-empts the White Paper on the Reform of Australia’s Tax System (The Treasury 2015b). The ideal approach would be to ensure appropriate tax collection and encourage cost effective ways of doing so.

8.3 Capturing the benefits of new business models

Governments and regulators face challenges from the expected pace of change in technological developments, with a few highlighted in this chapter. As regulation lags market developments, governments and regulators need effective mechanisms for monitoring emerging trends, a flexible approach and the ability to adapt and design regulation in a changing environment.

Regulator discretion in compliance and enforcement

Consistency and predictability in regulator enforcement behaviour provides an environment of certainty for businesses to operate (knowing how to be compliant with the opportunity to minimise compliance costs) and to invest and innovate. However, there are times when some flexibility and discretion by regulators in the use of compliance and enforcement tools could provide greater welfare benefits (or at least no loss in welfare) whilst still achieving the broad regulatory objectives. The Council of Australian Governments (COAG) recognises the value of discretion in enforcement noting that ‘an appropriate degree of flexibility to permit regulators deal quickly with exceptional or changing circumstances’ is needed (COAG 2004, p. 6).

In practice, regulators can exercise discretion on matters ranging from how they decide which areas to focus their activities, the approach they will take in doing that work to what enforcement tools will be used (and when). This section focuses on the latter — how regulator enforcement behaviour and the tools available to regulators could be used to better assess the risks and benefits of new business models, particularly those that may be operating in regulatory grey areas.

The Commission recognises that there are a number of factors that affect a regulator's approach and their ability to exercise discretion — some of which may be outside the control of regulators. Regulators will generally have greater scope for discretion when regulatory objectives are clear and regulations are performance or outcome-based, rather than being written prescriptively. Similarly, regulators need to be resourced so they have the capacity to attract and retain staff with the appropriate knowledge and skills capable of effectively undertaking their role, including when to exercise discretion (PC 2013e).

Businesses generally aim to comply with their regulatory obligations. New business models, however, often claim that they are not required to comply with regulations because their business model is different and not within the scope of the regulatory coverage. Furthermore, there are also times when it is unclear whether certain actions by a business is a contravention of the regulation, or even if certain actions are clearly a breach and there may be net benefits from allowing the new innovative business models to operate. However, when faced with pressures from a number of sources, regulators may seek to provide certainty by enforcing the regulations they are tasked to manage — requiring compliance by businesses and escalating the enforcement approach. Generally, this has been the case for Uber rideshare drivers and Airbnb hosts in a number of jurisdictions in Australia, notwithstanding considerable public support and demand for such services. (IPART estimated that 11 per cent of Sydney's population has used ridesharing services between April and November 2014 (IPART 2014)).

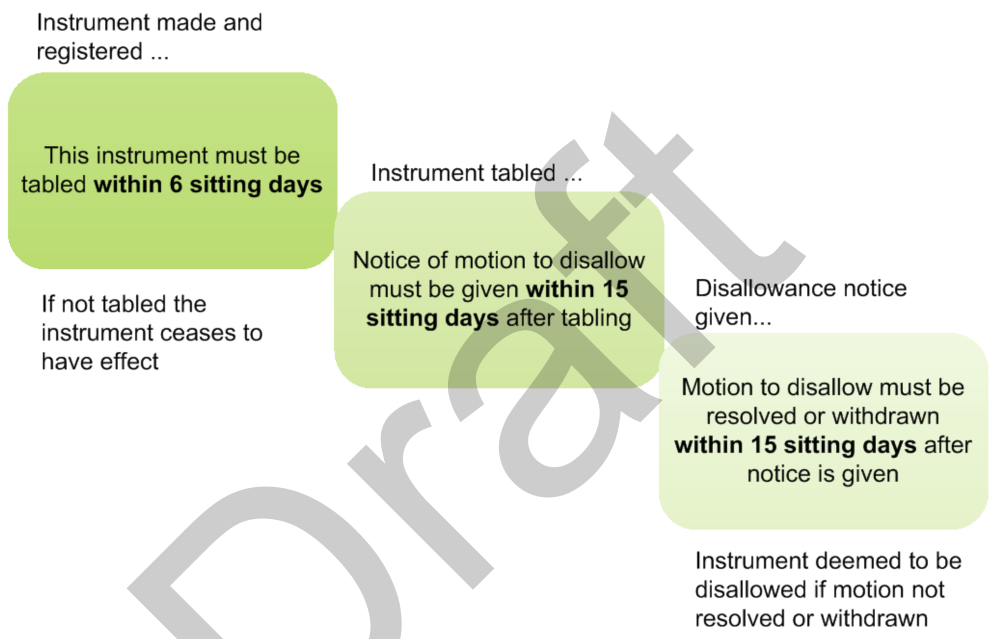
Fixed term exemptions

Fixed term exemptions from some regulatory requirements are potentially one tool that could be used by regulators. In the case of new business models, a fixed term conditional exemption would provide the regulator time to assess the benefits and risks of the new business activity against the objectives of the regulation in order to determine the appropriate longer term regulatory response. Such a process might be considered akin to the private ruling framework employed by the Australian Taxation Office. One critical difference of course, is that in the case of exemptions it would provide protection from legal action by competitors, not just the regulator — but only for the duration of the fixed term. Such an option would require each jurisdiction to legislate to provide such powers to regulators. The delegated power that would be given to the Minister, on the advice of the relevant regulator, to provide fixed term conditional exemptions would be a disallowable instrument and would follow the usual system for such instruments in each jurisdiction (figure 8.2).

Ideally, new businesses would have to apply to the relevant regulator for an exemption *prior to operating*. After seeking public comment and assessing the facts within a legislated timeframe, the regulator may choose to provide advice to the relevant minister requesting an exemption (for a limited duration) so long as the details of the business model remain substantially unchanged and is carried out as described. The regulator's advice to the Minister should be public. If the regulator decides not to provide advice, or the Minister rejects it, a public statement of reasons should be made available.

Providing an exemption has the effect of providing certainty, facilitating business activity and the opportunity for new businesses to invest and innovate in new ways of doing business. It also provides regulators an opportunity to watch and assess the risks and benefits of such activity.

Figure 8.2 **Usual disallowance system — Commonwealth**



Source: Parliament of Australia (2013)

No action letters

'No action' letters are another potential regulatory tool that could be used by regulators in regards to new business models in a rapidly changing technological environment. While the nature of this tool varies, it essentially allows a business to apply to a regulator for an expression of their regulatory intention regarding how they will exercise their powers under the relevant regulation (box 8.7). If granted, the regulator will provide a 'no action' letter in which it would state that the regulator does not intend to take regulatory action over the circumstances described.

The aim of a no action letter, is to provide some level of certainty in the market, facilitating business activity and the opportunity for the new businesses models to invest and innovate. It also provides regulators an opportunity to watch and assess the risks and benefits of such activity.

Box 8.7 **Broad principles of no action letters**

A regulator would only provide a no action letter when they form the view that:

- it would serve a clear regulatory purpose to provide a no action letter to an applicant
- it would not advance the policy of the legislation to take other regulatory action in relation to the conduct in question.

In reaching a view on these issues, a regulator would take into account their understanding of the intention of Parliament in enacting the legislation including whether or not:

- they have settled on a view on a subject
- there are other regulatory options available, such as exemptions or modification to provisions of relevant regulation
- there is doubt over whether the conduct would be lawful, it is transitional, or is not a serious flaw in compliance
- the impact on third parties is minimal.

Source: Australian Securities and Investment Commission (2009); Office of the Registrar of Indigenous Corporations (2013)

As with fixed term exemptions, these types of letters are specific to the facts and circumstances of a specific situation. However, they differ in that a no action letter does not rule out the potential for a regulator to take action in the future. As this tool is not legal advice, it can be withdrawn particularly if a regulator forms a regulatory view on the business model. Furthermore, a no action letter does not preclude third parties from taking legal action.

The Commission considers that a fixed term conditional exemption is the preferred tool as it provides greater certainty for the new business models to operate.

Regulatory review and reform

Regulatory discretion in the form of fixed term exemptions and no action letters are short term solutions to help regulators to keep pace with market developments. Ultimately, if regulations are constantly challenged or presenting barriers to new business models entering the market, regulation should be reviewed.

Regulatory restrictions on competition, which usually have well-meaning objectives (such as consumer safety), can have significant negative impacts on competition and consumer welfare. It is important that regulations are reviewed to ensure the design and implementation options are still effective to achieve the desired objectives. It may also be necessary to consider whether the overall objectives of the regulation need to change in line with changing community values and expectation. This is not to suggest all regulation should be removed but instead assess whether the means of achieving the regulatory objectives could be done better.

The recent competition policy review (Harper review) recommended all levels of government should review regulations to ensure that unnecessary restrictions on competition are removed (Harper et al. 2015). While the Harper review recommended a broad review of regulation, it highlighted some priority areas including planning and zoning and taxi regulation. Aside from the economy-wide benefits of better targeted regulation that may arise from such reviews, it should provide regulatory clarity for new business models and potentially lower regulatory compliance costs for incumbents.

DRAFT RECOMMENDATION 8.1

All jurisdictions should provide a framework for fixed term exemptions to specific regulatory requirements that deter entry by business models that do not fit within the existing regulatory framework.

Regulators should have the capacity to place conditions on the exemption to protect consumers, public health and safety, and environmental outcomes. Such exemptions should be disallowable instruments and subject to public review prior to expiry.

More generally, governments should:

- continually review industry-specific regulatory approaches to assess whether they remain relevant and provide a net benefit to the community and are the most effective and efficient means by which objectives can be achieved, and
- ensure that regulation and regulators are flexible and adaptive in the face of evolving technologies and business models and properly funded for this task.

INFORMATION REQUEST

The Commission seeks participants' views on other regulatory tools available and their merits, such as 'no action' letters, that would provide some regulator discretion around the operation of new business models.

9 Payment systems regulation

Key points

- Payment systems enable consumers, businesses and other organisations to transfer funds held in an account at one financial institution to others. Regulation is needed to safeguard the stability of the payment system; protect system users; and promote efficiency in the operation of systems. However, regulation can act as an impediment to entry (and expansion) of new and innovative participants. Therefore, regulation needs to balance maintaining the stability and safety of payment systems against the benefits of entry and competition.
- Innovative business models, including those based on stored value facilities where consumers pay in advance and later draw down on the stored payments, are expected to play a larger role in the payment system in the future. However, the existing regulatory framework for such facilities is complex. Uncertainty in regulatory thresholds as well as the regulatory burden of the Authorised Deposit-taking Institutions framework, provides a disincentive for stored value payment systems to grow in Australia.
- Ensuring access and competition in payment systems is the responsibility of the Australian Competition and Consumer Commission (ACCC), unless the payment system is designated by the Payments System Board (PSB) of the Reserve Bank of Australia (RBA).
- The RBA has designated and set access regimes for a number of payment systems, including MasterCard and Visa, promoting entry and competition in payment systems. However, in payment systems not designated by the RBA, such as Cabcharge payment instruments, competitors must approach the ACCC to dispute access. This leaves a potential gap between the ACCC monitoring of potential misuse of market power and a decision by the RBA to designate a payment system and impose an access regime.
- Digital currencies represent a potentially significant innovation that can facilitate fast and low cost transactions. Moreover, it is widely viewed that the public ledger technology used by many digital currencies could bring innovation beyond the financial services industry.
- However, there are a number of barriers to digital currency businesses setting up in Australia, including the timely development of a regulatory framework that protects currency users and mitigates money laundering and related risks. Moreover, the treatment of digital currencies as a type of intangible asset for GST purposes results in double reporting and double taxation for some transactions. Given the ability of currency users to easily switch to overseas providers, the GST treatment impacts on the competitiveness of Australian based digital currency businesses.

Payment systems enable consumers, businesses and other organisations to transfer funds held in an account at one financial institution to others. The collection of payment systems includes cash, cheques and electronic funds transfers used to make payments; as well as the payment settlement/clearing arrangements between financial institutions.

Consumers and businesses can choose between more traditional payment methods (such as credit cards and debit cards) as well as a number of networks competing to provide each of these instruments (for instance, Visa, MasterCard and American Express). Technological innovations have resulted in the development of a growing range of new payment instruments including mobile and online payment options, as well as contactless terminals and biometrics for payment authorisation.

Payment systems underpin most transactions in the Australian economy. New entrants into existing payment systems and the development of new alternative payment systems can promote competition and efficiency in the overall payment system and deliver benefits to the wider economy. Therefore, from a business set-up perspective, it is important that regulation does not favour incumbents and limit scope for the development of new payment systems, or for new business models to make use of existing payments systems.

This chapter considers:

- how clear and graduated regulation that reflects the relative risk of small players can support innovation and growth of new stored value payments systems as well as new business models using existing payment systems
- regulation that supports entry and competition in established payment systems
- how regulation of emerging digital currency businesses — particularly in regard to Anti-Money Laundering and Counter-Terrorism Financing, and how digital currencies (such as Bitcoin) are defined for GST purposes — can protect currency users whilst removing impediments to the growth of digital currency businesses in Australia.

9.1 Accommodating new business models in the existing payment systems

Payment system regulation aims to ensure safe, stable and efficient payment systems. In Australia, payment system providers are overseen by three regulators: the Australian Securities and Investments Commission (ASIC) is responsible for ensuring consumer protection and market integrity in payment systems; the Australian Prudential Regulation Authority (APRA) is responsible for supervising the safety and soundness of financial institutions whose activities give rise to liabilities in the payments system; and the Payments System Board (PSB) of the Reserve Bank of Australia (RBA) is responsible for ensuring systemic stability as well as efficiency and competition in the payment system. The Australian Competition and Consumer Commission (ACCC) applies the general competition law.

Recognising that regulatory burden can be an impediment to entry (and expansion) of new and innovative participants, elements of graduated regulation have been introduced over the past decade or so to open card scheme entry to non-banks (box 9.2) and to enable greater provision and use of stored value facilities. However, the existing regulatory regime is complex and presents a number of impediments to stored value payment systems, namely:

- existing regulatory thresholds lack clarity and may not reflect the degree of risk posed to consumers and the financial system
- strict liquidity requirements imposed on Purchased Payment Facilities (PPFs)[13] regulated by APRA can provide a disincentive for smaller stored value facilities to grow and enter the PPF regime; and place PPFs at a competitive disadvantage relative to other Authorised Deposit-taking Institutions (ADIs).

Impediments to use of payment systems

Recent technological developments have seen a number of innovative business models emerge, including Airbnb and Uber, that connect consumers and businesses in new ways and offer a secure payment platform. For instance, Airbnb collects payment from guests when a reservation is confirmed, but withholds the payment from hosts until after check-in. Technological development has also seen the successful introduction of numerous smart cards, including the widely used 'Octopus' card in Hong Kong and the 'myki' card in Melbourne.

These innovative businesses offer a range of benefits to consumers and the wider economy (chapter 8). However, as such business — and the amount of funds they hold with deposit-like characteristics — grows, the threshold at which the business will trigger prudential regulation as an ADI is unclear.

To ensure the safety and integrity of the payment system, widely used stored value payment systems that are deemed by APRA to be a 'banking business' must be registered as a PPF — a special class of ADI. APRA has discretion in deeming a facility to be carrying on a banking business based on certain characteristics of the facility — specifically, whether the facility is available on a wide basis as a means of payment, and the stored value is redeemable in Australian currency (figure 9.1). However, no minimum threshold of stored value is defined. PayPal is currently the only PPF supervised by APRA.

Uncertainly over thresholds for APRA regulations likely to be a concern for facilities that grow to hold over \$10 million in stored value and are otherwise not covered by RBA exemptions (discussed below). Such facilities must be licensed as an ADI by APRA or authorised by the RBA. To date, the RBA has not approved any stored value facilities.

For small stored value facilities, the current regulatory regime relies on a number of exemptions by the RBA and ASIC. In particular, the PSB of the RBA has declared that the

[13] PPFs are a class of ADIs that can undertake a range of banking activities including holding stored value, but are restricted from accepting deposits for the purpose of advancing money. The stored value held by a PPF is subject to APRA investment and liquidity requirements.

Payments Systems (Regulation) Act 1998 (Cth) does not apply to: loyalty schemes; gift card facilities; electronic road toll devices; and pre-paid mobile phone accounts. The RBA has also specifically exempted:

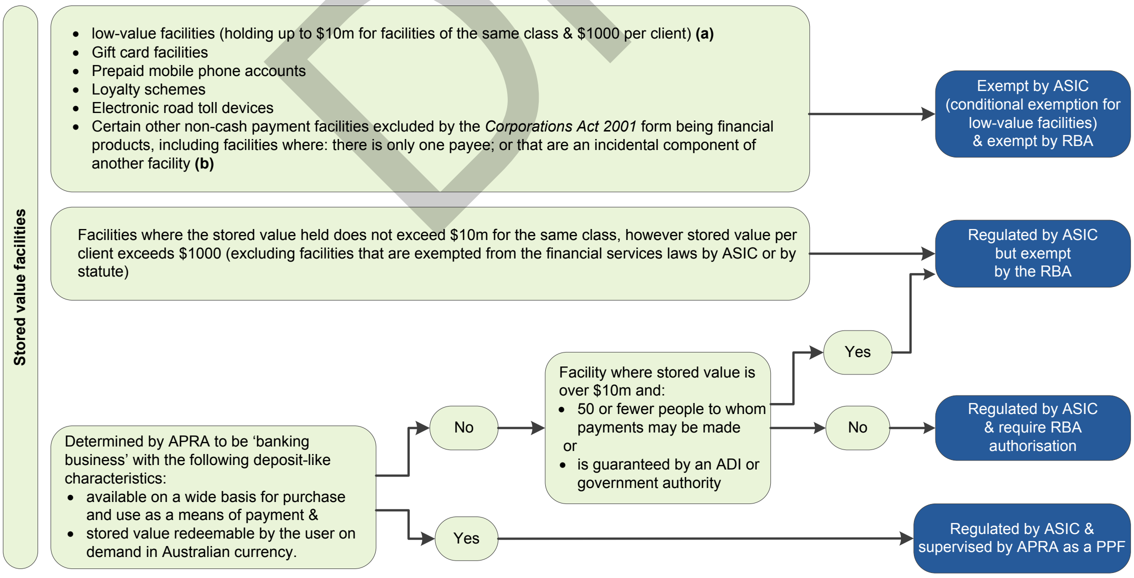
- 'limited-value PPFs' where the total amount of obligations to make payments does not exceed $10 million
- 'limited-participant PPFs' where the number of people to whom payments may be made does not exceed 50 persons, and
- corporations whose obligations to make payments is guaranteed by an ADI or commonwealth, state or local government authority (for example, the NSW Government's public transport smart card for Sydney, the 'Opal' Card).

Similarly, ASIC has provided relief from the Australian Financial Services licence and product and disclosure regime for a number of small non-cash payment facilities.

Therefore, for stored value facilities that pose little systemic risk, the existing regime relies on either explicit exemptions or on facilities remaining small (including holding less than $10 million in stored value) to exclude these facilities from regulation by ASIC and the RBA.

Figure 9.1 **Current regulation regime for stored value facilities**

For simplicity, facilities holding under $10 million in total stored value are assumed not to be determined by APRA to be a banking business



a Relief provided by ASIC to low-value facilities (holding up to $10 million for facilities of the same class and up to $1000 per client) is conditional on the facility complying with initial and ongoing conduct and disclosure obligations. Low-value facilities are also required to lodge a notice of reliance to ASIC. **b** Stored value facilities that are excluded by *the Corporations Act 2001* from being financial products, are also exempt from RBA regulation if the facility either: holds less than $10 million in stored value; has 50 or fewer people to whom payments may be made; or is guaranteed by an ADI or government authority.

Source: ASIC (2005, 2014d); RBA (2015b)

The implication of the current arrangements is that non-ADI stored value payment providers operate on a small scale (and remain under the $10 million cap set by the RBA) and/or arrange for an ADI to act as the holder of stored value. ASIC noted that the existing regime 'may encourage providers to engage in complex white labelling arrangements (e.g. non-ADIs distributing ADI-issued products) in an effort to sustain existing business models and to potentially avoid exceeding the low-value threshold and therefore attracting RBA and APRA regulation' (ASIC 2014d, p. 89).

Enabling wider use of stored value payment systems

Removing disincentives for stored value facilities to grow

The diversity of payment systems is likely to grow with technological innovations. Providing clear and transparent thresholds for graduating between levels of regulation, that reflect the relative risk posed to the stability of the wider payment system and consumers, will therefore become increasingly important.

The Financial System Inquiry (The Treasury 2014d) recommended enhanced graduation of retail payment system regulation, including clarifying ASIC and APRA thresholds to cover only 'large and widely used' payment systems. The inquiry suggested possibly defining 'large and widely used' such that:

- the only non-cash facilities that would be required to hold an Australian Financial Services license with ASIC would be those with: annual transaction of over $100 million and more than 50 payee groups; or annual transactions of over $500 million and more than 5 payee groups
- APRA regulation would only apply to stored value facilities that hold more than $50 million in stored value and allows individual customers to hold more than $1,000.

Providing graduation and clarity on the thresholds for APRA regulation in this way could encourage smaller stored value facilities to grow such that even if no longer a 'limited-value' or 'limited participant' PPF they might avoid being regulated as an ADI.

The Commission considers that ASIC, APRA, and the RBA, in consultation, should determine appropriate regulatory thresholds for the 'large and widely used' payment system providers. The thresholds should remove the need to specifically exempt small payment system providers. Enhanced graduation of ASIC and APRA regulation should help to 'future proof' the regulatory framework to accommodate payment systems — possibly not yet conceived or defined in the existing exclusions — based on the risks posed to consumers and the financial system.

The Commission supports changes to the prudential regulation of PPFs as recommended by the 2014 Financial System Inquiry — including setting the threshold for APRA regulation at potentially $50 million in total stored value — which should reduce any disincentives for stored value facilities to grow. The Commission considers that the threshold for APRA regulation of stored value facilities should be reviewed (or possibly indexed) over time to ensure that prudential regulation continues to be limited to 'large and widely used' facilities that pose a substantial risk to the wider payment system and/or consumers.

Competitive neutrality between PPFs and banks

For stored value facilities that are subject to prudential regulation, the existing APRA regulation of PPFs has similar capital requirements to that for ADIs, but has stricter liquidity constraints. Specifically, PPFs are required to hold high-quality liquid assets that are of equal value to their stored value liabilities. The 2014 Financial System Inquiry argued that the stricter liquidity constraints that stored value payment facilities face when regulated by APRA, can place these facilities at a competitive disadvantage in the payments system relative to other types of ADIs.

The Financial System Inquiry recommended introducing a new two-tier framework for APRA regulation of stored value facilities (The Treasury 2014d). The proposed first tier would maintain a 100 per cent liquidity ratio requirement but reduce other prudential requirements (to lower compliance costs). The second tier would reduce liquidity requirements potentially to be in line with those for banks, but strengthen other prudential requirements. Lower liquidity requirements should ensure competitive neutrality between PPFs and traditional ADIs.

The Commission agrees with the Financial System Inquiry that APRA should develop a two-tiered regulation framework of PPFs such that PPFs could choose between operating under 100 per cent liquidity ratio requirements or other strengthened prudential requirements.

DRAFT RECOMMENDATION 9.1

The graduated regulation framework for payment systems should be clarified and enhanced along the lines proposed in the 2014 Financial System Inquiry. The enhanced framework should be published to provide clarity to new stored value systems and should reflect the degree of risk posed to consumers and the financial system of sufficiently small payment system participants.

In particular, the Australian Securities and Investments Commission (ASIC) and the Australian Prudential Regulation Authority (APRA) administered regulation should only apply to 'large and widely used' payment system providers. In consultation, ASIC, APRA and the Reserve Bank of Australia should determine appropriate thresholds. APRA should also develop a two-tiered regulation framework for purchased payment facilities (PPFs) where PPFs can choose between operating under 100 per cent liquidity ratio requirements or other strengthened prudential requirements.

9.2 Access and competition in payment systems

Payment systems are characterised by large economies of scale and strong network economies (The Treasury 2014c). To compete, new entrants must build scale through acceptance by consumers and merchants. In the absence of competition, payment system incumbents with market power may: charge interchange or merchant fees significantly above costs; impose restrictive rules for merchants, including no-surcharging rules; and/or deny network access to potential competitors. For this reason, regulation that enables contestability in payment systems can improve efficiency in the payments industry and wider economy.

As noted in the previous section, regulating entry into and competition in the Australian payments system falls under the responsibility of both the ACCC and the PSB of the RBA. Specifically, competition and access to the payment systems is the responsibility of the ACCC under the *Competition and Consumer Act 2010* (Cth) unless a system is 'designated' by the PSB under the *Payment Systems (Regulation) Act 1998* (Cth). After 'designating' a payment system, the PSB is able to set an access regime for new entrants and standards for that system (box 9.1). The RBA works closely with the ACCC in setting payment system rules and access regimes.

Box 9.1 The Payments System Board

The *Payment Systems (Regulation) Act 1998* provides for the PSB of the RBA to regulate 'designated' payment systems. The PSB is able to designate a payment system where it is considered to be in the public interest to do so. The PSB is responsible for setting payments system policy with the aim of ensuring that payment systems are: safe (controlling risk in the financial system); efficient; and competitive. Where a payment system has been designated, following public consultation, the PSB can impose:

- an access regime
- make standards for safety and efficiency, including setting standards for merchant surcharges (to limit a merchant's surcharge to the 'reasonable cost of acceptance') and honour-all-cards rules (where, for example, merchants that accept Visa credit cards were required by Visa to also accept Visa debit cards)
- direct participants to comply with the access regime and standards, and
- arbitrate disputes in the system.

In recognition of joint responsibility for payment systems, the ACCC and RBA have entered into a Memorandum of Understanding regarding policy coordination and information sharing for the payment system.

To date, the RBA has designated a number of payment systems — including MasterCard, Visa, the EFTPOS, and ATM systems[14] — and imposed a number of access regimes and standards. For example, the 2006 Access Regime for the EFTPOS system imposed no-discrimination provisions and caps on connection charges designed to ensure that new participants had access to the system in line with existing participants (RBA 2012).

By imposing access regimes and setting interchange fee caps, some non-bank businesses have entered these designated payment schemes. Notably, Tyro (sub. 15, p. 1) credits its participation not only to the introduction of a special class of acquiring-only ADIs (providing card acceptance services to merchants) but also to the RBA 'forcing an access regime in 2004 and 2005 on the global card system and in 2005 and 2006 on the domestic debit card system (EFTPOS) and the clearing and settlement streams BECS [Bulk Electronic Clearing System] and CECS [Consumer Electronic Clearing System]' (box 9.2).[15]

[14] The RBA has designated six payment systems: MasterCard and Visa in 2001; Visa Debit and the EFTPOS System (broad definition) in 2004; the ATM system in 2008; and the EFTPOS system (EPAL) in 2012.

[15] However, Tyro (sub. 15) also notes that it has experienced difficulty expanding to compete for businesses that have a bank relationship manager. It attributes this difficulty to what it views as anticompetitive product bundling by banks and interchange fees that are used to cross-subside issuer costs to the detriment of specialist acquirers.

Box 9.2 Opening access to card systems in Australia

To ensure that payment system participants did not impose a significant settlement risk on the system, until 2003 access to the Visa and MasterCard systems was largely restricted to banks. However, regulators recognised that such restrictions limited competition among participants, and could not be justified as protecting the stability of the payment system.

To open entry to card schemes to non-banks, in 2003, a new class of ADIs called Specialist Credit Card Institutions (SCCIs) was established and licensed by APRA to perform card issuing (issuing credit cards to consumers) and/or acquiring businesses (providing card acceptance services to merchants). However, SCCIs were unable to accept deposits. Significantly, around the same time, the RBA imposed an access regime for the Visa, MasterCard and EFTPOS payment systems to ensure SCCIs were eligible to apply for membership in these systems on the same basis as other ADIs.

Despite these measures to reduce the barriers to entry, only two businesses registered as SCCIs — the card issuer GE Capital and the specialist acquirer Tyro. Tyro considers the introduction of SCCI together with the RBA setting access regimes for a number of payments systems, as a successful proactive regulatory change that enabled it to gain access to the core payment systems, and provide services to small and medium sized Australian businesses (sub. 15).

The RBA (2014c) recently concluded that limiting access to the MasterCard and Visa payment system to ADIs (when these schemes may be willing to accept non-ADI members) and the onerous prudential supervision of SCCIs (given the limited prudential risks), may deter potential new entrants. As a result, the SCCI regime was abandoned from 1 January 2015, to enable greater flexibility in card scheme membership.

Since 1 January 2015, credit card systems have been allowed flexibility to expand membership to non-ADIs. Accordingly, MasterCard has very recently approved WEX Finance as a new card issuer (BusinessWire 2015).

Issues identifying and designating relevant payment systems

Underpinning the design of the existing payments system regulatory framework is an emphasis on self-regulation (or co-regulation). The RBA takes a watchful approach to designating payment systems, intervening when a 'public policy issue arises that the industry is unable to address' (RBA 2014b, p. 8). As a result, many payment systems (and many aspects of designated payment systems) are unregulated by the RBA.

This framework provides relief from regulatory burden to new payment systems (such as digital currency businesses) and to smaller players that do not represent a significant risk to the stability and efficiency of the overall payment system. However, competitors denied access to undesignated systems are unable to ask the RBA to direct access to the system or to arbitrate disputes between participants. Rather, businesses that have a dispute about access must approach the ACCC (for action under the *Competition and Consumer Act 2010* (Cth)).

As a result, the existing regulatory regime leaves a gap between regulators being able to improve access only if presented with evidence of potential anticompetitive behaviour and being able to improve access through designating a payment system. In contrast, for a number of other industries with similar large network effects, such as communication industries, the ACCC has additional functions to monitor and enforce an access regime.

Indeed, while many central banks take an interest in payment system stability and efficiency, it is unique for the RBA to have responsibility for efficiency and competition in payment systems. The RBA (2015b) notes that these powers have broadened its traditional focus from 'high-value wholesale payment systems which underpin stability, to encompass the retail and commercial systems'. In comparison, the new UK independent payment systems regulator — the Payment System Regulator (PSR) established to take a stronger focus on competition and innovation — has taken over regulatory oversight of designated payment systems from the Bank of England (box 9.3). To safeguard the stability of the UK financial system, the Bank of England and the Prudential Regulation Authority have veto powers over PSR decisions.

Box 9.3 A new payment system regulator in the United Kingdom

Until recently, in the United Kingdom, once a payment system was designated by HM Treasury, the Bank of England would have formal oversight of that system. The Bank would set expectations on action to be taken by payment systems to address issues identified by the Bank. While these expectations did not carry any statutory force, the Bank had powers to impose penalties when payment systems did not comply.

To address issues with payment systems being dominated by a number of large banks, a new competition focused independent payment system regulator — the Payment System Regulator (PSR) — was established in the United Kingdom in April 2015 (HM Treasury 2013). The objective of the PSR is to promote competition, innovation in payment systems and the interests of end users. It is funded by industry, but sits as a separate body under the Financial Conduct Authority. The Financial Conduct Authority has concurrent competition powers for financial services, including to: conduct market studies and investigations; and to enforce against breaches of the prohibitions on anticompetitive behaviour.

Once a payment system is designated by HM Treasury, the PRS has regulation and competition powers to, among other things: set standards; impose requirements regarding system rules; require access for new entrants; amend agreements; and act where the PSR see anti-competitive behaviour (alongside the Competition and Market Authority) (PSR 2015). The PSR is also responsible for setting the strategy across the UK payments industry, which was previously the responsibility of the self-regulatory body, the Payments Council.

Cabcharge payment products are an example of a payment system where the ACCC has seen evidence of the misuse of market power, but has not been effective in imposing an access regime (box 9.4). Despite the ACCC being successful in its 2010 Federal Court case against Cabcharge for misuse of market power, no other taxi payment system provider has been able to obtain access to process Cabcharge payment products. In 2012, the Victorian Taxi Industry Inquiry called for the RBA to designate the Cabcharge payment system and impose an access regime if payment processors continued to have difficulty accessing Cabcharge payment instruments on reasonable terms.[16] In the absence of intervention by the RBA, a number of state governments have placed a 5 per cent cap on surcharging for electronic taxi fare payments, including governments of: Victoria (Napthine 2014), New South Wales (NSW Government 2014a), and Western Australia (DoT 2015).

Box 9.4 The Cabcharge payment system

Cabcharge dominates the taxi payment system in Australia. Cabcharge operates an electronic payment system consisting of: a Cabcharge-branded payment account accessed either through a voucher or card; and an electronic payment system 'Fareway' used to process transactions not only on Cabcharge accounts but also on other credit, charge and debit cards. Approximately 97 per cent of Australian taxis operate the Cabcharge Fareway EFTPOS system (Cabcharge 2015); and Cabcharge accounts comprise around 30 to 40 per cent of non-cash payments processed on Cabcharge terminals (Taxi Industry Inquiry 2012). Passengers paying their fares using the Cabcharge Fareway EFTPOS system are charged a processing fee of 10 to 11 per cent of the cab fare.

Over the past few years, a number of new taxi fare payment system providers (including GM Cabs, Live TaxiEpay and CabFare) and taxi booking apps (including ingogo and goCatch which offer payment processing systems via smartphones) have entered the Australian market. However, competing payment providers have been unable to gain access to process Cabcharge payment instruments.

In September 2010, Cabcharge was fined by the Federal Court for misuse of market power, including for refusing to allow competing suppliers of electronic payment processing services for taxis to process Cabcharge payment products (ACCC 2010). However, since the case, no other payment processor has obtained access to Cabcharge payment products. This means that taxi drivers are required to have multiple payment terminals in their taxi in order to accept Cabcharge-branded accounts as payment, as well as accessing other taxi payments providers such as CabFare (Tyro sub. 15).

Further, the Victorian taxi industry inquiry (2012, p. 208) found that 'consumers are not benefitting from competition between … service providers. Instead, each provider charges the same 10 or 11 per cent surcharge or fee to consumers for electronic payments and, rather than competing on prices charged to consumers, these providers use part of the surcharge to provide rebates to drivers and operators who use their systems'. The Victorian Taxi Industry Inquiry (2012) found that the 10 to 11 per cent surcharge on electronic payments was likely to far exceed the resource cost of providing the service — it recommended that the electronic payment taxi fee should be capped at 5 per cent.

Given the potential benefits to consumers across Australia and improvement to the efficiency of taxi payment system, the Commission considers that the RBA should designate the Cabcharge payment system and impose an access regime for Cabcharge payment instruments. Moreover, given the existing broad competition powers of the

[16] In November 2012, CabFare also requested that the RBA designate the Cabcharge payment system and set access fees and arrangements.

ACCC to monitor and to prevent illegal anticompetitive behaviour, the Commission also seeks participant views on the potential benefits of placing the powers to designate and regulate retail payment systems with the ACCC.

DRAFT RECOMMENDATION 9.2

The Payments System Board of the Reserve Bank of Australia should designate the Cabcharge payment system and set an access regime for Cabcharge non-cash payment instruments. The applicability of relevant aspects of the MasterCard and Visa access regimes for the Cabcharge payment system should be considered.

INFORMATION REQUEST

Would the powers of the Payments System Board of the Reserve Bank of Australia relating to access and competition in payment systems be more appropriately placed with the Australian Competition and Consumer Commission?

9.3 Digital currencies

Digital currency is an internet based form of currency that can be transferred, stored and traded electronically through peer-to-peer networks. Crypto-currencies are digital currencies that rely on cryptography to ensure the security of transactions. There are currently at least 610 digital currencies worldwide, although most trade in very small markets (such as for electronic gaming).

The crypto-currency, Bitcoin, is estimated to account for nearly 90 per cent of the daily trade of crypto-currencies worldwide (CoinMarketCap 2015); and is the most widely used digital currency in Australia (ADCCA 2014). The use of Bitcoin is growing rapidly, with the number of transactions each day almost doubling over the past two years — from an average of around 56 800 transactions per day globally in April 2013 to 106 500 transactions per day in April 2015 (Blockchain 2015).

In Australia, bitcoins are accepted by around 177 physical retail businesses (compared with a total 6498 businesses worldwide), including a range of cafés, book stores and other businesses (Coinmap 2015).

Bitcoins can be held using the Bitcoin open source software, users often store their bitcoins using a bitcoin ‘wallet’ with an intermediary. Various forms of digital currency intermediaries have also emerged and evolved (box 9.5), including a number of new Bitcoin businesses such as Bit Trade Australia, digitalBTC and ABA Technology.

Verification of transactions relies on a peer-to-peer network with no clearly identified operator (or central bank). A public online ledger (called the 'blockchain') records where each bitcoin unit is located and a history of all transfers in ownership. This has the advantage of being faster than conventional payment methods (moving from one address to another within an hour)[17] and potentially less costly (averaging 1 per cent of the transaction value across all bitcoin transactions).[18]

Box 9.5 Types of Bitcoin intermediaries

Exchange and trading platforms provide a market for buying and selling bitcoins for national currencies or other digital currencies.

Payments processors for merchants provide guaranteed-rate conversion facilities, and may also provide point-of-sale infrastructure and applications for merchants to accept bitcoin payments.

Intermediation for consumers to access Bitcoin exchanges or trading platforms, buying and selling bitcoins on consumers' behalf.

Bitcoin wallets store users' bitcoin addresses and sometime their private keys (a secure password) and generate messages to transfer bitcoins from one address to another (including to pay for goods and services).

Bitcoin ATMs allow uses to buy and sell bitcoin using cash.

Some intermediaries offer a combination of services, for example some Bitcoin exchanges also offer hosted-wallet services where the provider retains the users' private bitcoin keys.

Source: Lo and Wang (2014); RBA (2014a)

Digital currencies could deliver a number of potential benefits to users including for international remittances — where conventional methods can take longer than 3 days to occur and can cost on average 8 per cent of the transaction value (RBA 2014a). Lower transactions costs of digital currency could also facilitate the development of micro-payments, involving very small amounts of money, for goods and services such as downloading music and individual articles.

The key innovation of Bitcoin (that could have a large range of 'disrupting' applications) is the underlying technology that allows for the fast transfer of ownership of assets over the internet. For this reason, reducing impediments to digital currency businesses in Australia could bring innovation not only to payment systems, but also to a range of other industries

17 The RBA in partnership with payment industry participants is currently developing the New Payments Platform (NPP) to enable full scale real time payments for low-value payments in Australia. The NPP is estimated to become operational in the second half of 2017 (RBA 2015a).

18 Buying and selling bitcoins to make these transactions can add considerable additional transaction costs. The RBA (2014a) notes that adding Bitcoin intermediary fees to the costs of digital currency transfers, can result in a total cost to users comparable to that of conventional payment methods.

including for 'smart property' — where the ownership of property (such as cars, houses and shares) can be transferred on a decentralised peer-to-peer basis using a public ledger.

However, as demonstrated by the hacking and subsequent bankruptcy of the digital exchange Mt Gox in February 2014 that resulted in the unexplained disappearance of around 650 000 bitcoins (RBA 2014a), digital currencies carry risk for users. The (often substantial) price volatility in some digital currencies also increases risks to users.

Appropriate regulatory oversight could reduce barriers to entry

Digital currency businesses are largely unregulated in Australia. Indeed, such businesses were not contemplated when existing payment systems regulation was designed. This has benefits for the digital currency industry in terms of lower compliance costs, with the RBA noting that 'the lack of regulation may well be a factor contributing to the adoption of bitcoin by some users' (RBA 2014a, p. 9).

However, as noted above, there are a number of risks associated with widespread use of digital currencies that could act as barriers to digital currency businesses setting-up in Australia.

The risk that digital currency will be used in criminal activity due to the 'pseudonymity' nature of transactions with no link to the holder's true identity and the relative ease of transferring funds quickly across boarders has been acknowledged both internationally and in Australia (AUSTRAC 2011, 2014). The Financial Action Task Force noted the characteristics of virtual currencies, including the lack of a central oversight body, posed potential money laundering and terrorism financing risks (FATF 2014).[19] The main crimes involving Bitcoin in Australia to date include: online exchanges of illicit goods and services on Darknet marketplaces (such as the Silk Road, which was shut down in 2013); domestic supply and trafficking of narcotics with payment in bitcoin; alleged hacking theft of bitcoin; and money laundering and dealing with the proceeds of crime through bitcoin (AFP 2014).

In Australia, digital currency intermediaries fall largely outside the Anti-Money Laundering and Counter-Terrorism Financing (AML/CFT) regime regulated by the Australian Transaction Reports and Analysis Centre (AUSTRAC).[20,21] To the extent that users convert digital currency into and out of Australian dollars (or another foreign

19 The Financial Action Task Force is an inter-governmental body that develops and promotes policies to protect global financial systems against money laundering, terrorist financing and other related threats to the integrity of the international financial system.

20 AUSTRAC is Australia's AML/CTF regulator which oversees compliance with the reporting requirements of the *Anti-Money Laundering and Counter-Terrorism Financing Act 2006*.

21 E-currency (that is currencies not issued by, or under the authority of, a government body but backed by a precious metal or bullion) are covered under the AML/CTF Act. In contrast, digital currency not backed by a precious metal or bullion are not covered under the Act.

currency) with financial institutions, regulators have some (limited) visibility of transactions. Even so, the Australian Federal Police (2014, p. 4) noted that digital currency creates 'significant challenges for law enforcement in identifying and tracking the flows of illicit funds'.

It has been suggested that financial institutions in Australia are unwilling to deal with businesses that use Bitcoin due to the risk posed to the bank's reputation in the event of illegal transactions. ASIC (2014f, p. 16) noted that it is 'aware of a number of banks taking steps to cease dealing with bitcoin related businesses due to concerns that digital currency providers pose an unacceptable level of risk to the banks' business and reputation'. The Australian Remittance and Currency Providers Association (ARCPA 2014) suggest that the 'de-banking' is due to the perceived risk of money laundering and counter-terrorism financing. Concerns over money laundering and terrorism financing risk posed by offering designated services to digital currency businesses were also raised in submissions from the Australian Bankers' Association and the Australian Financial Conference to the Attorney-General's Department's statutory review of the *Anti-Money Laundering and Counter-Terrorism Financing Act 2006* (Cth) (AGD 2014).

Both the Australian Bankers' Association and the Australian Financial Conference put to the Attorney-General's Department's review that digital currencies should be designated under the Australian AML/CFT regime. However, regulation by AUSTRAC does not guarantee that banks will be willing to offer services to digital currency businesses. Despite being required to register with AUSTRAC, over the past few years, a number of remittance services have had their Australian bank account closed.

Similar issues have been raised in the United Kingdom, where businesses have reported being forced to open overseas bank accounts, slowing operations and increasing costs (HM Treasury 2015). In government consultation on digital currencies in the United Kingdom, submissions from the banking sector pointed to the lack of regulation as the main reason for not providing services to digital currency businesses. However, it was also put to HM Treasury that banks had made little effort to assess the risk of individual digital currency businesses; and that digital currencies are a potential competitive threat to established payment systems, of which banks are an integral part.

Citing the potential benefits of digital currency (and the underlying technology) and to deter illegal users, HM Treasury (2015) concluded that there is a good case for proportionate regulation of digital currency businesses. In March 2015, the UK Government indicated its intention to apply anti-money laundering regulation to digital currency exchanges.

Canada[22] and the United States[23] have also made moves to bring digital currency intermediaries under the relevant AML/CFT regulation. The experiences of digital currency businesses operating under the US AML/CFT regime suggests that the regulation has increased businesses' legitimacy, assisted in forming banking partnership and investments, and helped to deter criminals (HM Treasury 2015). However, compliance costs have posed an issue for smaller businesses, with the process of registering in multiple American states forcing some of them out.

While digital currencies are currently only traded in very low volumes with a relatively small number of businesses accepting payment in digital currency, the industry could potentially grow rapidly. The Commission considers that given the money laundering and related risks, as well as the likely low costs of regulation, digital currency intermediaries should be included in the AML/CFT regime in Australia.[24]

The Commission also supports the development of a self-regulation framework by the industry to address consumer protection issues without imposing prohibitive compliance costs on small businesses. Indeed, Australian Digital Currency Commerce Association has proposed a self-regulatory governance framework enforced through it member code of conduct, to give customers greater confidence in digital currency services (ADCCA 2014). A similar approach has been taken in the United Kingdom, where the Government has announced that it 'will work with BSI (British Standards Institution) and the digital currency industry to develop voluntary standards for consumer protection' (HM Treasury 2015, p. 4).

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The Australian Transaction Reports and Analysis Centre should regulate digital currency businesses for anti-money laundering and counter-terrorism financing purposes, given the high growth potential of digital currencies and the likely low costs of including them within the regulatory framework.

22 Canada introduced legislative change to require money services businesses dealing in virtual currencies to be regulated under Canada's AML/CFT regime in 2014 (FINTRAC 2014). The new regime will come into force after regulations and associated guidance are published.

23 In 2013, the US Financial Crimes Enforcement Network (FinCEN) provided guidance bringing administrators or exchangers of convertible virtual currencies — that is, digital currency with an equivalent value in real currency or that acts as a substitute for real currency — under the money services businesses registration, reporting and recordkeeping regulations for anti-money laundering purposes (FinCEN 2013).

24 The effective regulation of digital currency is currently being considered by a Senate Inquiry (due to report in August 2015), and as part of a statutory review of the *Anti-Money Laundering and Counter-Terrorism Financing Act 2006* (Cth) by the Attorney-General's Department.

Appropriate GST treatment could reduce barriers to digital currency businesses in Australia

In August 2014, the Australian Taxation Office (ATO) issued a draft ruling on the tax treatment of crypto-currencies that viewed crypto-currencies as a form of intangible property — rather than as money or currency — and, therefore, did not count as a financial supply for GST purposes (ATO 2014).[25] As a result, bitcoin transactions are akin to a barter arrangement for property and GST is due on the supply of bitcoins. This has two key consequences for digital currency transactions in Australia: double GST reporting and double taxation.

First, when a GST-registered business sells goods to another GST-registered business using bitcoins, the first business must remit GST for the sale of goods (as with conventional payment methods), but the second businesses must also remit GST for the sale of the intangible good 'bitcoins'. In this case, both businesses are entitled to claim back the GST paid on their inputs (referred to as an 'input tax credit') and do not have a GST liability as result of the transaction (as with conventional payment methods). However, the double reporting of GST imposes additional compliance costs. The Bitcoin Foundation and Bitcoin Association of Australia (2014, p. 17) note the 'increase the paperwork that is required to report each transaction … will reduce or remove the advantage the business receives from bitcoin's low value transaction cost'.

Second, when an Australian based business (such as an exchange or ATM) supply bitcoin to an Australian customer (or non-GST registered business), GST is due on the supply of bitcoin, increasing the price by 10 per cent (figure 9.2). When the customer makes a purchase using bitcoins, GST is due on the sale of the goods. The customer is charged GST twice — first when they acquire Bitcoin and, second when use bitcoin to purchase goods. Therefore, it is more expensive for individuals to acquire bitcoin from an Australian based exchange compared to an overseas exchange.

In contrast to the supply of crypto-currency, the supply of foreign currency is a 'financial supply' and as such GST is not applied to the exchange. For example, ignoring transaction fees for simplicity, GST adds an additional $100 to the transaction cost for an individual to acquire A$1000 worth of bitcoin compared to A$1000 worth of US dollars.

As digital currency users can easily shift to overseas suppliers, the current classification of crypto-currencies as intangible property for GST purposes places Australian based businesses at a disadvantage to overseas competitors where sales tax is not charged on the supply of digital currency. Bitcoin Foundation and Bitcoin Association of Australia further notes that the GST treatment of crypto-currencies is hindering its adoption in Australia and, that it is 'aware of a number of Australian based bitcoin

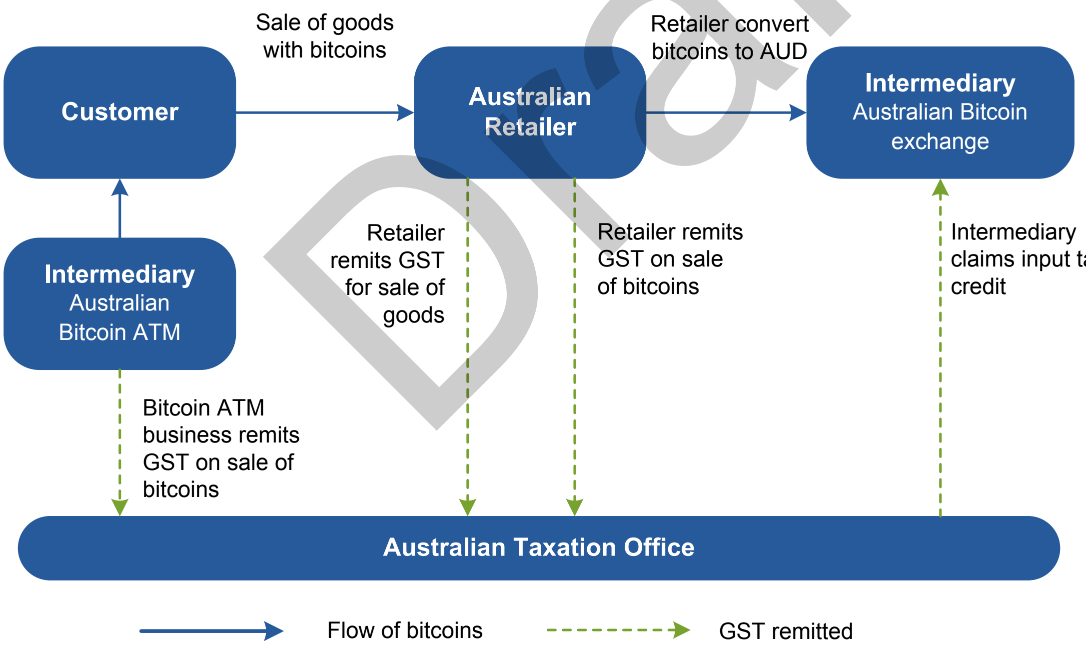
25 The ATO determined crypto-currencies to be a form of intangible property for capital gains tax (CGT) and fringe benefits tax (FBT) purposes. ATO (2014) has more details on the tax treatment of business income, capital gains and remuneration in bitcoin, income from mining bitcoins and disposing of bitcoin acquired for investment.

businesses moving operations offshore to remain competitive in a global market for the supply of bitcoin' (Bitcoin Foundation and Bitcoin Association of Australia 2014, pp. 18–19).

Following the ATO ruling in late 2014, the Australian start-up CoinJar relocated to the United Kingdom, noting that the ATO ruling on GST made it uncompetitive against non-Australian rivals (CoinJar Pty Ltd 2014). In the United Kingdom, crypto-currencies were reclassified from gift vouchers to money for tax purposes and are now not subject to value added tax (HM Revenue & Customs 2014).

Given the ability of currency users to easily avoid paying GST when acquiring crypto-currencies, including bitcoin, by using overseas suppliers and the resulting disadvantage imposed on Australian based digital currency businesses, the Commission supports adopting a similar approach to the UK Government to treat crypto-currencies as a financial supply for GST purposes.

Figure 9.2 **Bitcoin transactions and resulting GST implications: an illustrative example**



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Crypto-currencies, such as Bitcoin, should be treated as a financial supply for GST purposes. This would require that the definition of money be updated to include crypto-currency in both the *A New Tax System (Goods and Services Tax) Act 1999* (Division 195) and relevant GST Regulations.

10 Other government and industry restrictions

Key points

- Restrictions on new business entry come in many guises and there is urgent need for governments to revisit restrictions that they deliberately or inadvertently impose. This is particularly necessary in markets facing 'disruption' brought on by new business models.
- Businesses starting out may enter into a wide range of contracts with other businesses. Potential barriers are switching costs on early termination of a contract, unfair terms and conditions, and aspects of retail leasing and franchising arrangements.
  - Onerous switching costs can be reduced through greater transparency in contracts about exit fees and costs. Governments are taking steps to address other barriers.
- Government procurement presents an opportunity for new businesses to start up. Aspects of procurement practices such as complex prescriptive tender documents, slow assessment processes and lack of confidentiality afforded to unsuccessful tenderers deter some business participation and set-up.
  - Governments should review their practices to encourage diversity, choice and innovation and reduce compliance burdens, particularly on small business.
- Land tenure arrangements can create barriers to new business set-up, transfer and closure. Governments should maintain or pick up momentum on land reforms — especially those toward more diverse and longer leases to enable new businesses to engage in a wider range of activities, and to enable the transfer or use of land as security for debt financing.
- While there are some aspects of the Australia Government's review regime for foreign investment proposals that could be improved, they do not appear to create a significant barrier to foreign investment and, thus, to business set-up, transfer and closure.
- Other potential barriers to business set-up, transfer and closure include a lack of competitive neutrality, governments imposing conditions on purchasers of privatised assets, import restrictions, and voluntary industry codes and requirements.

In addition to those government and industry restrictions covered elsewhere in this report, there are other restrictions that could potentially be barriers to business set-up, transfer and closure. These include:

- government restrictions on new entry into markets
- business to business contract arrangements
- government procurement processes
- foreign investment restrictions.

- land tenure arrangements
- other government and industry arrangements.

10.1 Government restrictions on new entry

Governments impose various restrictions on new entry that can directly affect business set-up. These restrictions include limits on the number, operating hours, ownership and location of businesses. They address a number of objectives including ensuring the quality of a good or service, ensuring consumer protection and safety, managing the costs to consumers and governments, achieving minimum returns for providers, and maintaining a domestic industry capability.

The objectives of restrictions on new entry may be valid in that they seek to address market failures such as a lack of information on service quality. For example, under the National Registration and Accreditation Scheme, a national board for each health profession sets standards and policies that health practitioners must meet to be registered. One of the objectives of the Scheme is to 'help keep the public safe by ensuring that only health practitioners who are suitably trained and qualified to practise in a competent and ethical manner are registered' (AHPRA 2015).

However, it is not always clear that the objectives address a significant problem, or that restricting new entry is the most desirable solution. In particular, restrictions reduce the benefits that competition can bring through lower prices, higher quality, more consumer choice, and innovative products and services. For example, in recommending the removal of restrictions on the production and sale of fresh potatoes in Western Australia, the Economic Regulation Authority, noting they were introduced after the Second World War to ensure supply and control price levels, said they:

> … have raised the incomes of potato growers in Western Australia. However, this has been at the expense of Western Australian consumers, who have paid higher prices than would otherwise have been the case, have limited choice of potato varieties and have endured poor product quality. The restrictions have also limited productivity growth in the industry. (ERA 2014, p. 20)

The Commission has examined a number of restrictions on new entry in markets in past studies — for example, pharmacies (PC 2005a), aged care (PC 2011b), occasional childcare centres (PC 2014c), and retail trade (PC 2011c, 2014e). It has generally concluded that the costs of reduced competition exceed the benefits and recommended either the removal of the restrictions, or a review by an independent body to improve market efficiency.

Recently, the Harper Review of competition policy (Harper et al. 2015) recommended removing a number of anti-competitive regulations including restrictions on retail trading hours, parallel imports, and pharmacy location and ownership rules. It also recommended that other regulations restricting competition be reviewed by each jurisdiction, with particular priority given to regulations covering planning and zoning, taxis and ride-sharing, and product standards

The Commission endorses the Harper Review's recommendations. Restrictions on new entry can be a significant barrier to business set-up. There is an urgent need for governments to revisit their restrictions to assess whether they generate a net benefit to the wider community, or whether the restrictions are the only or best way of achieving government objectives. This is particularly necessary in markets facing 'disruption' brought on by new business models (chapter 8).

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Governments should implement the Harper Review's recommendations with respect to removing or reviewing industry-specific anti-competitive regulations. In reviewing their regulations, governments should assess whether they generate a net benefit to the wider community or whether they are the best way of achieving government objectives.

10.2 Business to business contracts

In starting out, businesses are likely to enter into a number of contracts with other businesses to supply or obtain a range of goods and services. Contracts may be between the new business and their suppliers, providers of services, landlords, franchisors, and/or business customers.

Aspects of business contractual arrangements that can impede business set-up, transfer and closure include switching costs, unfair terms and conditions in standard form contracts, and certain terms and conditions in leasing and franchising arrangements. A common theme underlying each of these barriers is an imbalance of power between the parties in negotiating the contracts.

Switching costs

Businesses starting out that are cash constrained may opt for the cheapest upfront contracts even though there are substantial costs for contract termination. Such costs — broadly termed switching costs — include early exit fees and difficulties associated with 'porting' (say, a bank account number) when a contract terminates. They can occur with a range of contracts, including for mobile phone, internet and banking services (Harris 2012).

The presence of switching costs does not necessarily mean there are significant barriers to business exit. Provided there is competition in the relevant market and full disclosure in contracts of exit fees and costs, switching costs are likely to be offset by price discounts and other benefits that the business receives upon entering the contract.

However, switching costs that are onerous, or undisclosed in contracts, can prevent businesses from seeking efficiencies by changing suppliers, create barriers to a business exiting at a time of their own choosing and make it difficult for other suppliers to increase market share.

Concerns about switching costs in retail banking were the basis for the Australian Government introducing a switching scheme in 2008 for ordinary transaction accounts. In his review of the scheme, Fraser noted that its contribution to account switching was 'miniscule' possibly due to limited customer awareness (2011, pp. 11, 12). His suggested improvements included extending the scheme to small businesses. However, subsequent reforms (which included a ban on exit fees for home mortgages) did not address this (Australian Government 2012a). The Commission notes that, while a working party was established to consider extending the scheme to small businesses, its work has not progressed. It also notes that data received by the Treasury on the reformed scheme (The Treasury, pers. comm., 13 March 2015) indicates that it has not contributed significantly to switching behaviour.

The Commission considers that, in general there does not appear to be a strong case for governments to specifically address switching costs in contracts beyond current laws relating to fair trading and business operations.[26] Current laws should assist in making many switching costs (for example, exit penalties) transparent. Moreover, while switching costs may occur in contracts, there are beneficial trade-offs for businesses. Even if there were a role for governments, evidence of the operation of the banking switching scheme for ordinary transaction accounts suggest that such intervention could have limited additional benefits (additionality).

Standard form contracts

Many business-to-business contracts are standard form contracts that are negotiated at business set-up. They are used for a wide range of transactions including for telephone, internet and electricity services, commercial leasing, debt financing, and the supply of goods and services.

In such transactions, new small businesses share many similarities with individual consumers:

- They often do not have the capacity to seek or understand legal or professional advice when entering into contracts.

[26] Contracts are generally regulated by laws relating to fair trading and business operations, chiefly the *Competition and Consumer Act 2010* (Cth) (incorporating the Australian Consumer Law), the *Australian Securities and Investments Commission Act 2011* (Cth), *the Corporations Act 2001* (Cth), and the common law.

- Given their small size, their bargaining power is typically lower than that of the other party, especially if the contract is offered on a 'take it or leave it basis'.
- Where contracts are long and technical, they may be unwilling or unable to read the whole contract.

A cash constrained new small business may also be willing to accept standard form contracts with low up front costs in exchange for less flexibility in terminating the contract.

There are currently two forms of protection against unfair terms and conditions in standard form contracts.

The first form are provisions in the Australian *Competition and Consumer Act 2010* (Cth) that protect small businesses and consumers from unfair and unconscionable conduct in business and consumer transactions. In a recent Federal Court case, the provisions were used successfully against Coles Supermarkets Australia who was found to have engaged in unconscionable conduct in its dealing with more than 200 of its suppliers in 2011 (Harper et al. 2015, p. 356).

The Harper Review considered that the Federal Court case indicates that the current unconscionable conduct provisions appear to be working as intended. However, it considered that active and ongoing review of these provisions should occur (Harper et al. 2015, p. 356).

The second form of protection are provisions in the Australian Consumer Law that render unfair contract terms in standard form consumer contracts as void. These provisions were introduced in 2011 in line with the Commission's recommendation in its consumer policy framework report for a new provision that proscribed unfair terms in consumer to business contracts that caused consumer detriment (PC 2008d).

The Commission notes that the Government is committed to extending to small businesses the kind of protections against unfair contract terms and conditions that are available to consumers under the Australian Consumer Law (Bilson and Abbott 2015; Bilson 2014, p. 1). The Government has released for public consultation draft legislation to give effect to the extension.

The Commission supports an extension of current protections in the Australian Consumer Law against unfair contract terms and conditions to small businesses, particularly as they share many similarities with individual consumers. Crucial issues in implementing any extension to small businesses include identifying what is a 'small business' and what contracts should be within scope.

Commercial leasing arrangements

A common step in the set-up of businesses is to enter into commercial leasing arrangements covering property, vehicles, plant or machinery. A particular type of lease that has been problematic for businesses is retail leases.

Several issues have been raised about retail leases by participants in this inquiry (National Australia Bank, sub. 7), in past Commission inquiries on retail leasing (PC 2008a, 2011c, 2014e), and in a recent Senate inquiry (Senate Economic References Committee 2015).

One issue is that tenants often do not have a first right of refusal when renewing a retail lease. This means that when a retail lease reaches its end, the tenant is not given the opportunity to enter into a new contract before other interested parties. This could result in viable tenants being forced to exit. Although a first right of refusal would prevent this, participants have suggested that this could unfairly diminish the rights of the landlord (Shopping Centre Council of Australia, sub. 19, p. 10). Such a provision may also act as a barrier to the start-up of new businesses, as landlords would have a reduced ability to negotiate with new potential tenants. The benefits and costs of such a provision would therefore need to be carefully considered before being implemented.

Another issue relates to the obligations of tenants with respect to store fit-out and refits. Particularly where a leased retail space is located within a shopping centre, a contract may stipulate that the lessee is required to pay for high quality fit-outs in order to maintain the overall appeal of the centre. While some fit-out requirements are necessary to comply with relevant legal requirements or standards, such as those relating to energy efficiency and disability access, at issue are those requirements that are over and above such standards. These requirements may act as a barrier to business entry, or force unviable tenants (or those who wish to exit) to continue operating to recover costs. Neighbouring retailers and the landlord also benefit from high quality fit-outs, due to the improved image of the surrounding area and its attractiveness for customers and other new tenants. That such requirements must be clearly specified in a lease agreement and can form part of initial contract negotiations, diminishes the case for any government intervention on this.

A final concern relating to leasing arrangements is the inconsistency of regulations imposed by different state and territory governments (National Australia Bank, sub. 7, attachment, p. 8), which can add to complexity and the costs of businesses operating across jurisdictions. National inconsistency is more likely to be an issue for large established national businesses, rather than businesses setting up for the first time.

Some state and territory governments have implemented changes in the regulatory framework around retail tenancy leases in recent years or are undertaking reviews (box 10.1).

Nonetheless, the Commission considers that state and territory governments should continue to implement recommendations from previous inquiries and reviews including in regard to: improving transparency and disclosure requirements in lease terms, establishing timely and low cost dispute resolution arrangements; reducing the prescriptive nature of legislation; and moving towards a more nationally consistent framework.

Box 10.1 Recent state and territory progress on retail tenancy reform

- The New South Wales Government established the NSW Small Business Commissioner in mid-2011. The Commission undertook a review of the State's retail tenancy legislation in 2013 and 2014. It is finalising its review and is yet to release its findings.
- The Queensland Government reviewed its retail tenancy legislation between 2011 and 2013. It introduced a Bill in November 2014, which included new disclosure requirements for key lease categories and enhanced protections for lessees. The Bill automatically lapsed with a change of Government in January 2015. The Bill has been referred to the Government's Legal Affairs and Community Safety Committee for detailed consideration.
- The Victorian Government made a number of changes in 2012 and 2013, including the removal of some reporting obligations for landlords, and streamlined disclosure statements.
- The Western Australian Government updated legislation regarding disclosure statements and relocation clauses in 2013.
- The South Australian Government commenced a review of its legislation in December 2014.

Source: Legal Affairs and Community Safety Committee (nd); PC (2014e); SERC (2015); Small Business Commissioner (SA) (2014)

Franchise arrangements

Many people start up a business for the first time by purchasing a business through a franchise arrangement. Under a franchise arrangement, the franchisor assigns a franchisee the right to market or distribute their good or service, and to use the business name for a period of time (FCA 2013). Franchise arrangements are subject to a mandatory Code of Conduct that is monitored and enforced by the Australian Competition and Consumer Commission (ACCC) (box 10.2).

Recent concerns about franchising arrangements and the Code, identified by the recent Wein Review of the Franchising Code of Practice (2013) and others, have included:

- 'onerous' contract requirements offered by franchisors on a 'take it or leave it' basis; a lack of transparency and disclosure by franchisors in relation to marketing funds and online sales
- the lack of a pre-entry, cooling off period for franchisees entering a franchise agreement
- transfer, renewal and end of agreement terms and conditions that enable franchisors to stop franchisees from exiting the way they want
- difficulties in aligning the duration of retail leases with duration of the franchise agreement, which can result in one agreement concluding earlier than the other resulting in the franchise business trying to negotiate an extension on the other where all other parties know their vulnerability

- the effects of franchisor failure on franchisees and, in particular, how they sit with respect to creditors and employees in recovering outstanding debts and entitlements from the franchisor.

Box 10.2 The Franchising Code of Conduct

Franchising arrangements are subject to a Franchising Code of Conduct, which was first introduced in 1998 to:

- address the imbalance of power between franchisors and franchisees
- raise the standards of conduct in the franchising sector without endangering the vitality and growth in franchising
- reduce the costs of resolving dispute in the sector
- reduce the risk and generate growth in the sector by increasing the level of certainty of all participants (Trade Practices (Industry Codes–Franchising) Regulation 1998, Explanatory Statement, pp. 2–3).

The Code, which is a prescribed mandatory code under the *Competition and Consumer Act 2010* (Cth), broadly requires franchisors to disclose specific facts to franchisees and to follow set procedures in their dealings with franchisees. The Code also provides a dispute resolution scheme. The Australian Competition and Consumer Commission has responsibility for ensuring compliance.

A new Code was introduced following the Wein Review on 1 January 2015. This included: an obligation on franchisors and franchisees to act in good faith in their dealings with one another; a requirement for franchisors to provide prospective franchisees with a short information sheet outlining the risks and rewards of franchising; a requirement for franchisors to provide greater transparency in the use of marketing funds; a requirement for additional disclosure about the ability of the franchisor and a franchisee to sell online; and financial penalties and infringement notices for serious breaches of the Code.

Given the implementation of the new Code is very recent, the Commission considers it prudent to monitor the new arrangements and examine any outstanding concerns in the review of the Code due in five years.

10.3 Government procurement practices

Government procurement provides opportunities for new businesses to set-up to supply a wide range of goods and services. These include the cleaning and maintenance of buildings, the construction of bridges, the installation and management of Information Technology systems, and the provision of aged care services. Around 8 per cent of all businesses are involved in government procurement, with larger businesses more likely to be involved than smaller businesses (ABS 2014g).[27]

However, various participants, the Commission in its past studies, and others have identified barriers in government procurement practices to the participation of businesses, particularly of small businesses (for example, Future Perspective, sub. 17; the Australian Small Business Commissioner, sub. 10; Harper et al. 2015, pp. 269–282; PC 2014d; PwC 2013, p. 23; Senate Finance and Public Administration References Committee 2014, pp. 41–45). These barriers include complex and prescriptive tender documentation, a focus on inputs and outputs rather than on outcomes, requirements to include local content, the slowness of processes, the lack of effective communication with tenderers, and a lack of confidentiality afforded to unsuccessful tenderers. While concerns largely reflect the experiences of established businesses, they also signal potential barriers to the set-up of new businesses.

There may be valid rationales for aspects of government procurement practices. For example, complex and prescriptive tender documentation may be intended to ensure that taxpayers' funds are spent effectively with minimal risk. However, these practices may not only deter the set-up of new businesses, but also inhibit innovative cost-effective approaches to meeting a government's needs.

Governments have introduced reforms to their procurement practices in recent years, particularly to encourage small business participation. For example, in 2014, the Australian Government introduced several changes, including: a simplified process for tendering for contracts below $200 000 with standardised terms and conditions; online guidance during the tendering process; a 'low risk grant template'; and allowing the use of credit and debit cards for the purchase of goods and services under $20 000 (Minister for Finance and Minister for Small Business 2014).

There have been suggestions for further reforms to government procurement practices (for example, PwC 2013, pp. 23–24; Senate Finance and Public Administration References Committee 2014, pp. 41–61). PriceWaterhouseCoopers (PwC 2013, pp. 23–24) noted the use of electronic procurement systems that enable pre-registration or pre-authentication of tenderers such as the Korean Government's Korea ON-line E-Procurement System ('KONEPS').

Recently, the Harper Review on competition policy (Harper et al. 2015, p. 277) considered that governments could take steps to encourage diversity, choice and innovation in procurement practices. It suggested tendering with a focus on outcomes rather than inputs and outputs, trials of less prescriptive documents, and education and information sessions about procurement processes. It recommended that all governments should review their procurement practices (and all their commercial arrangements with the private sector and

[27] Around 34 per cent of businesses with 200 employees or more are involved in government procurement compared with 6 per cent businesses with fewer than 5 employees.

non-government organisations) and that competition principles be incorporated into procurement practices (Harper et al. 2015, rec 18).

The Commission endorses the Harper Review's suggestions on government procurement practices.

10.4 Land tenure arrangements

Land tenure is an important aspect of business set-up, transfer and closure. It can affect the types of activities that a new business undertakes, the ability of a new business to access finance, and the ability of owners to sell a business in the future.

There are many different types of land tenure (Geoscience Australia 1993). The most common types are Crown leasehold (mainly pastoral) and freehold, which are regarded as privately owned land. Together these types of land tenure account for 60 per cent of Australia, with most of this being Crown leasehold. Other types of land tenure include: Aboriginal freehold, leasehold or reserves (accounting for 14 per cent of Australia);[28] vacant and other Crown land (11 per cent); nature conservation reserve (8 per cent); defence land, forestry reserves, water reserves and mixed category land (4 per cent); and marine reserves.

Government land tenure arrangements currently address a range of objectives, including: providing certainty in property rights; controlling the use of land for particular purposes such grazing of cattle, environmental protection, or neighbourhood amenity; controlling access to 'common property' resources attached to land such as oil, minerals and fishing; enabling recognition of Aboriginal and Torres Strait Islander 'traditional or customary rights'; and raising revenue from taxation or royalties.

However, several reports (Australian Government 2014b; CSIRO, James Cook University and The Cairns Institute 2013; Forrest 2014) have drawn attention to the restrictiveness of land tenure arrangements. For example, the Green Paper on Developing Northern Australia (Australian Government 2014b, pp. 35–36) noted with respect to Western Australia, the Northern Territory and Queensland that:

- the three jurisdictions have separate tenure arrangements covering pastoral leases, Indigenous freehold and leaseholds, and native title, which can affect businesses operating across the jurisdictions.
- a property can be subject to overlapping land tenure arrangements (for example, it could be on Crown land, held under a pastoral lease and include Indigenous rights under native title)

[28] According to the Overcoming Indigenous Disadvantage report, 18 per cent of Indigenous owned or controlled land is Crown leasehold land, whereas 78 per cent is of uncertain tenure being 'tenure not stated' SCRGSP (2014, table 9A.2.1).

- information on tenure and land administration — and the processes involved in leasing or purchasing land — is not easily accessible
- pastoral leases allow landholders to undertake specific activities, usually grazing livestock, but restrict other land use (such as horticulture or tourism)
- Indigenous land arrangements in Western Australia and the Northern Territory do not usually allow for land to be converted to unrestricted freehold or be used as security for finance
- processes under the native title system, despite improvements, can be complex and involve uncertainties and delays in resolving claims.

Such restrictive land tenure arrangements can be barriers to business set-up, transfer and closure in various ways. A property subject to multiple or overlapping land tenure arrangements can add to the costs, delays and uncertainties of negotiating to undertake a particular use of the land (for example, mining). A land tenure such as pastoral leasehold can limit the entry of businesses wanting to engage in activities such as horticulture or tourism. Arrangements that do not allow for land tenure to be converted to freehold can reduce the ability of individuals to access finance as mainstream lending institutions generally do not lend against land holdings that cannot be sold.

Government reviews and reforms to land tenure arrangements are underway in a number of jurisdictions (for example, Queensland) to simplify processes, encourage more flexible and innovative land use and increase certainty for business.

The Commission urges governments to maintain momentum in land reforms, particularly given a significant proportion of land is held as Crown leasehold.

DRAFT RECOMMENDATION 10.2

Governments should maintain the pace of reform to their land tenure arrangements, particularly focusing on those that may inhibit the establishment of new businesses. Consideration should be given to the scope and duration of leases on land, flexibility of land titles, native title determination processes and the accessibility of land tenure information.

10.5 Foreign investment restrictions

Foreign investment can be a low cost source of debt or equity finance for new businesses starting out in Australia, involve the creation of new foreign-owned or controlled business in Australia, and involve the full or partial acquisition of existing Australian businesses.

While largely 'welcoming' of foreign investment (The Treasury 2013), the Australian Government through the Foreign Investment Review Board (FIRB) reviews foreign investment proposals under the *Foreign Acquisitions and Takeovers Act 1975* (Cth) to determine whether they are contrary to the 'national interest' (box 10.3 sets out the types of proposals that require approval).[29] After conducting a review, FIRB advises the Treasurer on whether or not to allow a proposed investment, or on what conditions need to apply. Responsibility for making decisions rests with the Treasurer. On 2 May 2015, the Government announced reforms to the foreign investment framework, including that it would conduct further consultation on options to modernise and simplify the framework (Abbott and Hockey 2015).

29 This 'national interest' is not defined under the Act. National interest considerations include: national security; competition; impact on other Government policies including taxation; impact on the economy and the community; and the character of the investor (Hockey 2015).

Box 10.3 Restrictions relating to business set-up, transfer and closure under the Foreign Acquisitions and Takeovers Act

- Foreign government investors must notify the Government and get prior approval before making a direct investment or starting a new business in Australia, regardless of the value of the investment. They are exempt from this requirement if they have previously established a new business in the same industry.[30]
- Foreign persons (individuals and businesses) must notify and get prior approval in the following cases:
  - before acquiring a substantial interest (15 per cent or more) in, or control of, an Australian business that is valued above $252 million
  - before acquiring a substantial interest (15 per cent or more) in an offshore company whose Australian subsidiaries or gross assets are valued above $252 million
  - to make investments of 5 per cent or more in the media sector, regardless of the value of the investment
  - acquisitions of interests in rural land where the foreign person already holds or will hold $15 million or more of rural land
  - to take an interest (including a lease of more than 5 years) in developed commercial real estate (including hotels, motels, hostels and guesthouses) that is valued at $55 million or more – unless the real estate is heritage listed, then a $5 million threshold applies
  - all interests in vacant commercial land and residential real estate.
- However, consistent with Australia's free trade agreements, foreign persons from China, Japan, Korea, New Zealand and the United States are subject to different thresholds. If seeking to:
  - acquire an interest in an Australian business or an offshore company, the threshold is $252 million threshold in sensitive sectors (for example, media, telecommunications, transport, defence and military related industries, and the extraction of uranium or plutonium or the operation of nuclear facilities) and $1094 million in other sectors
  - to take an interest in developed commercial real estate, the threshold is $1094 million.

Source: Australian Government (2015c); Hockey (2015)

The vast majority of foreign investment in Australia is not required to be screened by FIRB. During 2013-14, the value of proposed business-related foreign investment (that is, foreign investment not related to residential real estate) approved by FIRB was approximately $133 billion (FIRB 2015b). Business-related foreign investment accounted for a small share of FIRB approvals in terms of numbers (4 per cent), but a majority of approvals in terms of value (79 per cent) (table 10.1).

[30] A new business includes: starting a business in Australia (this includes applying for an exploration licence, applying for an Australian Business Number, taking out a lease, engaging employees, or entering business contracts); if already operating a business in Australia, commencing a new primary activity that is not incidental to an existing primary activity and that falls within a different ABS Australian and New Zealand Standard Industrial Classification Division,

Table 10.1 **Foreign investment proposals approved by FIRB**

2013-14, by industry

Industry	*Share of approvals based on number*	*Share of approvals based on value of the proposed investment*
	%	%
Agriculture, forestry & fishing	0.2	2.0
Finance & insurance	0.1	1.0
Manufacturing	0.2	6.3
Mineral exploration & development	1.0	13.4
Resource processing	0.0	0.0
Services	0.8	31.9
Tourism	0.0	0.8
Real estate (commercial)	1.6	23.8
Total business-related[a]	**4.0**	**79.3**
Real estate (residential)	96.0	20.7
Total[a, b]	**100.0**	**100.0**

[a] Totals may not add due to rounding [b] Excludes (internal) corporate reorganisations, of which there were 89 in 2013-14.

Source: FIRB (2015b)

Although the objective of FIRB reviewing foreign investment proposals is to ensure they are not contrary to the national interest, there are several aspects about its approach that could potentially be barriers to foreign investment and to business set-up, transfer and closure.

FIRB uses *monetary thresholds* to determine whether foreign investments by private investors are significantly large to warrant review. For example, prior approval is required for investments representing a 15 per cent, or greater, share in a business with at least $252 million in total assets. Concerns have been raised that these thresholds are disproportionately low, particularly when compared with other countries (Law Council of Australia, sub. 14, attachment 2, p. 4). However, as over 99 per cent of proposals are decided within 30 days and relatively few investments that are reviewed are rejected (FIRB 2015b), the thresholds do not appear to be significant barriers.

That said, the Commission notes that a higher threshold of $1094 million applies with respect to foreign investors in China, Korea, Japan, the United States and New Zealand through free trade agreements with these countries (although a $252 million threshold still applies for investments in sensitive sectors). There would be merit in the Government considering the application of the same higher threshold to all countries in accordance with the most favoured nation principle.

Unlike a private investor, a *foreign government investor* must notify the Government and get prior approval before making a direct investment or starting a new business in

Australia, regardless of the value of the investment. This requirement addresses concerns that foreign government investors invest for political rather than commercial reasons.

However, the Law Council of Australia suggested that the additional scrutiny faced by foreign government investors is more onerous when compared with other countries (sub. 14, attachment 2, p. 2). It suggested that the broad definition of foreign government investor be amended to distinguish between foreign governments, sovereign wealth funds and state-owned enterprises. Although this would potentially allow FIRB to apply different levels of scrutiny to different types of public foreign investments, there may be resulting complexities and sensitivities. For example, it may be difficult for FIRB to apply review requirements to state-owned enterprises if these entities differ significantly from country to country.

Concerns have been raised about *uncertainties* in the Government's approach to foreign investment proposals (Lowy Institute 2015). These arise from the Treasurer's discretionary power to determine proposals on a case-by-case basis, the lack of an express definition of 'national interest' in the Foreign Acquisitions and Takeovers Act, FIRB's use of varying monetary thresholds for different types of foreign investment, the ability of FIRB to administratively alter these thresholds, and that the thresholds can be altered through free trade agreements. It has been suggested that Australia could benefit from a more clear and uniform policy towards foreign investment, rather than allowing increased FIRB thresholds to be negotiated in free trade agreements (Lowy Institute 2015). The Commission considers that the Government's planned simplification of Australia's foreign investment framework would ideally reduce uncertainty and increase transparency around threshold changes.

Currently, no fees apply to foreign investment applications. From 1 December 2015, the Australian Government will introduce *application fees* (Australian Government 2015c). For business-related applications, it has proposed that the fee would range from up to $10 000 for new business proposals to $100 000 for business acquisition proposals (table 10.2). In introducing fees, the Australian Government considered that the cost of administering the foreign investment framework should not be borne by Australian taxpayers. The Commission notes that against a $252 million Australian asset monetary threshold involving a 15 per cent foreign interest, the proposed fee of $10 000 for a new business proposal could account for 0.03 per cent of the value of the foreign interest. It also notes that no evidence has being given on the potential impact of the fees on foreign investment proposals.

Table 10.2 Proposed fee schedule for business-related foreign investment proposals by private investors

Type of business-related foreign investment	*Proposed fee of up to*
New business	$10 000
Business acquisition	$25 000
Investments in agribusiness	$25 000
Business and agribusiness acquisitions where the value of the investment is greater than $1 billion	$100 000

Source: Australian Government (2015c)

While there are some aspects of Australian Government's approach to the review of foreign investment proposals that could be improved, the Commission considers that in the context of this inquiry they do not appear to present significant barriers to business set-up, transfer and closure at this time. Most foreign investment in Australia is not subject to restrictions and most business-related foreign investment that is screened by FIRB is approved in a timely manner.

10.6 Other potential barriers

There may be other government and industry restrictions that could potentially be barriers to business set-up, transfer and closure. The Commission invites participants to comment on the restrictions below (or any other restrictions). Comments should cover the nature and scale of any barriers created by the restrictions, their impacts on economic performance, and options.

Restrictions on the purchasers of public assets

The conditions that governments may place on purchasers of public assets can directly apply to the set-up, transfer and closure of the privatised business. Conditions may include the specification of the business structure of the purchaser, employment obligations or requirements to provide services in particular locations or at a particular price, or restrictions on the transfer or sale of the business assets.

For example, the New South Wales Government has committed to imposing several 'strict' conditions for the partial long-term lease of its electricity networks as part of its Rebuilding NSW State Infrastructure Strategy 2014 (NSW Government 2014c, 2014d). The conditions are intended to address the 'public interest' and include that: electricity network prices are discounted by 1 per cent off forecast regulated prices until 2019; there is no adverse impact on electricity reliability; the jobs of employees are protected and treated consistently with previous transactions; and the regional presence of the network businesses is maintained.

The Commission considers that governments should seek to maximise community wide net benefits as public assets are transitioned to privatisation. While conditions such as the above are intended to address community concerns about privatisation, they can be a barrier to the set-up and operation of the newly privatised business, and affect their future viability and efficiency. In its study on electricity network regulatory frameworks, the Commission recommended that governments should avoid the transfer to the new owner of 'unjustified liabilities, obligations or restrictions that may inhibit the future efficiency of the business' (PC 2013c rec. 7.3). Governments can address community concerns about privatisation more directly and transparently — for example, through separate agreements with the business.

Competitive neutrality

Governments compete with privately owned businesses in a wide range of markets, including transport, energy, telecommunications, education, health, commercial land development, construction, accommodation, printing, insurance and childcare.

A lack of competitive neutrality can deter the entry of privately owned businesses or hasten their exit by affecting their viability. For example, local government ownership and operation of a caravan park, that does not pay Goods and Services Tax (GST) or payroll tax, may be a barrier to the entry of privately owned competitors.

All Australian governments have committed to competitive neutrality policy and principles under the Competition Principles Agreement in 1995, which are intended to ensure that government businesses do not 'enjoy any net competitive advantage simply as a result of their public sector ownership' (COAG 1995). Although there is variation in implementation among the jurisdictions, competitive neutrality generally applies to government agencies undertaking 'significant business activities' and requires that the prices charged reflect costs.

In this inquiry, Family Business Australia raised concerns on behalf of a Victorian business about the State Government's implementation of competitive neutrality stating that without some form of action the business will fold (sub. 38, p. 1).

Similar concerns about implementation, particularly by small business, were also raised with the Harper Review of competition policy (Harper et al. 2015, pp. 258–266). It recommended that all governments review and update their competitive neutrality policies against best practice, increase the transparency and effectiveness of their complaint-handling processes, and strengthen the transparency of their competitive neutrality reporting (Harper et al. 2015, recs. 15 to 17).

The Commission endorses the Harper Review's recommendations on competitive neutrality.

Import restrictions

Businesses in starting out may seek to import goods or services as low cost inputs to their activities, or for distribution in the domestic market. Businesses may also seek to use professionals with overseas qualifications to provide low cost advice relating to set-up, transfer or closure.

Restrictions on the imports of goods and services are wide ranging. They include import tariffs, rules of origin requirements, quarantine restrictions, import licensing requirements, and technical requirements and standards.

While many import restrictions are intended to protect domestic industries, consumers and the environment (Australian Trade Commission nd), they can also reduce economic efficiency, add to regulatory burdens, and be barriers to business set-up, transfer and closure.

For example, in its inquiry on access to justice arrangements, the Commission noted concerns by participants that requirements in relation to the recognition of a legal practitioner's overseas qualifications are rigid and excessive (PC 2014a, p. 251). This suggests that the requirements could be impeding access to potentially low cost legal advice on business set-up, transfer or closure.

The Commission notes that, while import restrictions can be a significant barrier to business set-up, transfer and closure, they are an area that has been the subject of ongoing review (for example, PC 2014g; WTO Secretariat 2015) and reforms. Moreover, Australia remains committed to the World Trade Organization focus on multilateral liberalisation of goods and services trade (Australian Government 2015e).

Voluntary industry codes of practice and requirements

In starting out, a business may consider joining an industry association that require its members to meet a code of practice or other requirement.

The extent to which meeting an industry requirement is a barrier to business set-up depends on the benefits to the new business compared with the costs. Key benefits include more customers, information and advice, networking opportunities, education and training, financial discounts, dispute resolution and advocacy. Costs might include those from complying with the requirement and membership fees in joining the relevant industry association.

An industry requirement could also prevent, or significantly add to the costs of, non-industry association members setting up a business. An example is the Cabcharge payment system, originally established by the taxi industry to facilitate non-cash payments, which has prevented competing payment providers from being able to process Cabcharge payment instruments. The Commission has recommended changes to improve access to the Cabcharge system (chapter 9).

The Commission notes that, based on information from the ACCC, there do not appear to be voluntary industry requirements that are a significant barrier to business set-up, transfer and closure.

It also notes that the ACCC has a role under the Competition and Consumer Act with respect to industry codes of conduct. It may deal with complaints about voluntary codes, authorise voluntary codes on public benefit grounds, provide guidance to industries looking to develop their own voluntary codes, and monitor and enforce mandatory codes prescribed under the Act.[31] The Commission sees no reason for this role to increase further.

[31] The five mandatory industry codes prescribed under the Competition and Consumer Act are the Franchising Code, Horticulture Code, Oil Code, Wheat Port Code and Unit Pricing Code. The ACCC can also provide guidance to industries looking to develop their own voluntary industry codes.

11 How governments assist businesses

Key points

- Governments provide a variety of assistance to new and established businesses to: encourage entrepreneurialism, including through high growth businesses; support businesses that are 'small'; promote development and employment, including structural adjustment in particular industries and locations; and to address particular social goals. Sometimes this assistance aims to address a problem in the way markets operate (such as the existence of information problems or to generate positive spillovers), but more often than not, it is simply intended to improve economic or social outcomes.
- Common assistance measures include: information and advice; financial assistance such as grants, subsidies, guarantees, concessional loans, and tax concessions; mentoring, skills and training; collaborative mechanisms; and office space and facilities. Much of this assistance targets the set-up phase of a business.
- Government assistance, whether it is seeking to promote entrepreneurialism, small business or social goals, is less effective in the face of broader regulatory and taxation barriers to investment and competition.
- Any new assistance programs should: incorporate clear and credible objectives; be of limited duration (assistance should not be provided in perpetuity); and be subject to ongoing performance monitoring and independent evaluation including transparent assessment of the economy-wide net benefits. Along with other impacts of assistance, governments should consider the net impacts on business set-up, transfer or closure.
- With respect to existing programs, governments should give priority attention to their role in providing assistance through information and advice; mentoring, skills and training; and business incubators. There is a clear need for governments improving the effectiveness of advice related to regulation, programs and processes through streamlining services and ensuring proper resourcing of these activities. Beyond this, in light of increasing private sector involvement, governments should review their funding and programs to avoid displacing or duplicating private sector activity. This includes in particular, critically evaluating the net impact of efforts to attract new businesses to particular locations.
- Entrepreneurialism is an important feature of markets and can result in beneficial outcomes for the wider community in terms of job creation and economic growth. Governments should prudently consider and evaluate the potential for beneficial knowledge and network spillovers from such business activity. Any promotion of entrepreneurialism by governments should target market failures that are barriers to entrepreneurialism (rather than specific business models, industries or locations).

All levels of government — Commonwealth, state and territory, and local – provide assistance relevant to the set-up, transfer and closure of businesses.

The chapter begins by reviewing the main types of government assistance. Some types of assistance, notably that related to access to finance and tax concessions, are examined elsewhere in the report (tax measures in chapter 4, concessional loans in chapter 7, and small business capital gains tax concessions in chapter 12).[32] The chapter then investigates the main rationales for, and impacts and concerns about, government assistance. It concludes with some general directions for reform.

While existing approaches to government assistance are used to illustrate particular issues, the Commission does not assess or make recommendations about specific programs, nor does it aim to provide an exhaustive list of all current programs.

11.1 Types of government assistance

Government assistance that is relevant to business set-up, transfer and closure can range from the provision of: information and advice; grants and subsidies; tax concessions; mentoring, skills and training; concessional loans; collaborative and networking mechanisms including office space; and trade missions and awards. Much of this assistance is provided directly by government agencies to individuals and businesses, or by way of other agents such as not-for-profit organisations (including industry associations) and other businesses. Significantly, much of it is most relevant — and intentionally so — to the set-up stage of a business, but is also available to established businesses.

Information and advice

The most common form of government assistance is the provision of information and advice (table 11.1 with respect to assistance provided by the Australian Government). Information and advice is often delivered online, but it may also be delivered through a government agency, a call centre, a business mentor, an industry association, or a 'business incubator' (including business enterprise centres, which are discussed below).

Information and advice may be: of a 'sign posting nature' — directing individuals and businesses to superior sources of information and advice; general in scope; or customised to a particular business or topic (such as relating to government regulation and assistance programs, or relating to commercial matters such as accessing finance, setting up a digital business, or exporting).

[32] Including new measures to assist small businesses and start-ups announced in the 2015-16 Federal Budget.

Table 11.1 Australian Government assistance through information and advice

Assistance measure or program (Government agency)	*Description*	*Objective*	*Main relevance to set-up (S), transfer (T), or closure (C)*
Austrade	Provides information and advice to assist Australian exporters and education providers on how to do business (including setting up a business) in international markets.	To reduce the time, cost and risk for business associated with exporting.	S
Australian Business Licence and Information Service (ABLIS, Department of Industry & Science)[a]	Provides online information about government licences, permits, approvals, registrations, codes of practice, standards and guidelines that businesses need to know to meet their compliance responsibilities.	Not stated.	S
Australian Small Business Advisory Services (AusIndustry)	Provides, through not-for-profit organisations, advice to small businesses on business management skills, financial management skills, business planning, mentoring for business and general business advice.	To maximise the growth potential, prosperity and sustainability of small businesses through enhanced access to information and advice on issues important to establishing, sustaining and/or growing a small business	S, T, C
Business Development and Assistance Program (Indigenous Business Australia)	Provides, among other things, access to business advice, like marketing and business planning for start-ups and businesses wanting to grow.	To promote and encourage Aboriginal And Torres Strait Islander self-management and economic self-sufficiency[b]	S, T, C
Digital Business website (Department of Communications)	Provides a resource for small business and community organisations, or individuals thinking about setting up a business or community organisation, that want to learn more about how to develop an online presence or how an online presence may benefit them.	To maximise the benefits of the digital economy for all Australians.	S
Entrepreneurs Infrastructure Programme (AusIndustry)	Offers, through a national network of more than 100 private sector advisers, support to businesses through three elements: Business Management; Research Connections; and Accelerating Commercialisation.	To promote business competitiveness and productivity at the firm level.	S

(continued next page)

Table 11.1 (continued)

Assistance measure or program (Government agency)	*Description*	*Objective*	*Main relevance to set-up (S), transfer (T), or closure (C)*
Single Business Service (AusIndustry)	Consists of a consolidated online service, a contact centre and a face-to-face network to link businesses with relevant government programs and services. It includes insights into business improvement strategies and information on planning, starting and running a business as well as referrals to assistance programs.	To help business access government services and navigate government information.	S, T, C
Small Business Hub (ASIC)	Consists of an online resource that provides information for small businesses such as about their legal obligations as a small business owner, starting and closing a business, and what happens when a company is deregistered.	Not stated.	S, C
Small Business Support Line (AusIndustry)	Offers small businesses a consolidated online presence, a contact centre and a face-to-face network to link interested businesses with relevant government programs, information and advice.	To streamline access to essential information and government services for businesses.	S, T, C

[a] Delivered by a partnership of Australian, State and Territory Governments. [b] Objective of Indigenous Business Australia, not the program.

Source: ABLIS (nd); ASIC (2015b); Australian Government (nd); Australian Trade Commission (nd); Department of Communications (2015); IBA (2014)

In providing information and advice, governments primarily seek to address information problems, particularly the costs for some individuals or businesses in acquiring information and advice. For example, the Australian Government stated that its Single Business Service 'recognises that in the past, businesses have struggled to access government services and navigate the wealth of government information available to find what they need or who to talk to' (Australian Government nd).

Some participants (Australian Small Business Commissioner, sub. 10, p. 2; NAB, sub. 7, attachment, p. 17) considered that small businesses, in particular, benefit from government information portals such as business.gov.au, ASIC's Small Business Hub and the Australian Business Licensing Information Service (ABLIS). However, the Commission has received little comment about the benefits of government provision of information and advice relating to commercial matters (for example, preparing business plans or accessing finance).

There appear to be few if any Australian studies on the impacts of government provision of information and advice on business set-up, transfer and closure. What studies exist (box 11.1) suggest that: programs can have modest beneficial outcomes, such as on business sales and product range; and the form of information delivery can affect these outcomes.

Box 11.1 Studies on the impacts of government business and advisory programs

- Mole, Hart, Roper and Saal (2008) compared UK businesses that, in 2003 received (under the publicly funded Business Link network) 'intensive' and repeated advice and those businesses that received limited or no advice. They found that those businesses that had received intensive advice experienced significantly greater employment, but not sales growth, compared with the other groups. Businesses that received limited advice performed no better than those receiving no advice in the following two years.
- Cumming and Fischer (2011) found that, based on a sample of around 228 Canadian early stage businesses (of which 101 used publicly funded advisory services), the services were positively associated with sales growth, patents, angel equity finance and alliances.
- Kösters and Obschonka (2011) examined publicly funded business advice delivered to nascent entrepreneurs in Germany. They distinguished between two groups — entrepreneurs receiving 'intense' assistance across all areas of business and those receiving less intensive assistance limited to operational matters. They could not substantiate that business advice translated to better start-up performance. However, they considered that their results indicated that advice may help founders with fewer resources to overcome barriers in the start-up process.
- In their review of studies that evaluated the impact of UK technology and innovation advisory services, Shapira and Youtie (2014) considered the studies generally found positive benefits for participating businesses. The benefits include reductions in costs, improved quality, higher productivity, and new product development and innovation. The net benefits achieved were 'typically relatively modest although commensurate with the relatively small amounts of public funding usually invested' in the services.
- Sawang et al. (2014) surveyed around 250 Australian businesses who completed a small business advisory program. They found that programs involving: high levels of collective learning and tailored approaches enhanced business' perceptions of their skills and capabilities; and that practice-based approaches enhanced business' subsequent organisational innovation.

Some participants had concerns about government assistance through information and advice. Regional Development Australia — Northern Territory expressed concerns at the lack of information and advice at the very beginning of business set-up — for example, advice on what business structure and model would be most appropriate to particular circumstances (sub. 16, p. 1).

NAB noted feedback from business stakeholders and industry groups that, in the context of information about existing regulation, there is significant useful information available for businesses, but it is not always easy to find (sub. 7, attachment, p. 17). It considered there were opportunities to improve accessibility to information and recommended:

> Federal Government to create a national small business portal, expanding on business.gov.au, to act as a 'onestop' shop for small business requiring information on meeting their regulatory and compliance needs. ABLIS [The Australian Business Licence and Information Service] to be used as a template for the portal. (sub. 7, attachment, pp. 17–18)

Other participants, such as the Small Business Development Corporation (sub. 28, p. 8) and the Australian Charities and Not-for-Profits Commission (sub. 9, p. 4), supported a single entry point or one-stop shop for businesses.

In considering these concerns, and the scope for improvement, it is useful to distinguish information and advice about government regulations, programs and processes from that about commercial matters.

Information and advice about government regulation, programs and processes

It seems self-evident that governments should provide information and advice about matters in which they have a direct involvement or require compliance — such as regulations, programs and processes.

As part of its report on regulator engagement with small business (PC 2013e), the Commission set out a number of principles and leading practices with respect to the communication, information and consultation strategies of government agencies. These include: a focus on brevity and clarity; making greater use of third parties such as industry associations; using many channels of communication, information and consultation, including printed guidance, websites, seminars, help desks and face-to-face interaction. These principles and leading practices are also relevant to large businesses and individuals interested in setting up a business.

The current trend towards government use of one-stop shops and information portals can reduce the costs for individuals and businesses seeking information. The Commission considers that governments should build on this trend and examine the scope for further combining existing one-stop shops and portals.

Information and advice about commercial matters

The case for governments making available information and advice to individuals and businesses about commercial matters — such as which business structure to use, how to write business plans and how to raise finance — requires further justification. This is largely because of the current availability of private sector sources of this information and advice (for example, accountants, banks, lawyers, and industry associations). Indeed, Jay and Schaper (2003) noted that the most commonly consulted advisory services by around 70 home-based businesses in Perth were provided by accountants, banks, other business operators, and family or friends.

Mentoring, skills and training

Another common type of government assistance relevant to business set-up, transfer and closure — often provided together with information and advice — is mentoring, skills and training (table 11.2). Assistance may be delivered through the education system (schools and tertiary institutions), business mentors, or a business incubator. It may also be targeted to particular groups within the community (Indigenous people) or to business types (small businesses).

Table 11.2 **Government assistance through mentoring, skills and training**

Assistance measure or program	*Description*	*Stated objective*
Canberra Business Point (ACT Government)	Provides a gateway to practical advice and support for existing businesses and those intending to start-up a business in Canberra. Provides workshops, mentoring programs, one-on-one consultation, 'master' classes, targeted clinics and networking events.	To build strong foundations and encourage innovation for Canberra businesses.
Entrepreneurs Infrastructure Programme — Business Management (Australian Government)	Supply chain facilitation services offer businesses practical assistance to connect with and supply into project opportunities and new markets	To support individual small and medium businesses build capability and facilitate greater connectivity within the supply chain.
Entrepreneurial Pathways Program [a] (Tas Government)	Provides mentoring , education and training on the pathway from ideas to market for potential start-ups.	Not stated.
Medical Research Commercialisation Fund (Vic, NSW, WA, Qld and SA Governments)	Offers mentoring to individuals interested in setting up or developing a small business around medical research.	To support the development and commercialisation of early stage medical technologies.[b]
Startup Queensland (Qld Government)	Delivers entrepreneurship training (along with practical information and networking opportunities) to Queensland's start-up community.	To help build capability within the Queensland start-up community.

[a] Under development. [b] One of the program benefits.

Source: Australian Government (nd); CBP (nd); DSITIA (2015a); MRCF (2015); Tasmanian Government (sub. 18)

The main rationale for providing this type of assistance is to address information problems — such as the costs for individuals or businesses acquiring mentoring, skills and training. Another rationale is to address perceived deficiencies in the level of skills and training that individuals have at the set-up stage of a business that may contribute to business failure — this is considered later.

As with government support through information and advice, there appear to be few if any Australian studies that have examined the impacts of government support through mentoring, skills and training on business set-up, transfer and closure. For example, a study by Waters et al. (2002) of the Australian Government funded New Enterprise Incentive Scheme was inconclusive of the impact of mentoring on profitability during the first year of the new business (box 11.2).

Given the absence of evaluations of mentoring, skills and training programs, the Commission considers there is a need for governments to improve the evidence base in this area.

Box 11.2 **A study on the impacts of assistance through mentoring**

Waters et al. (2002) examined the impact of mentoring under the Australian Government funded New Enterprise Incentive Scheme. The scheme assists unemployed people to start-up a new business through a 7 week training program and the provision of a mentor to guide in the implementation of the business plan. Mentoring (by volunteers who were successful in their own business and careers) was provided for the first 12 months of the business set-up. Based on a survey of 77 scheme participants and 68 mentors, the authors found that:

- mentors provided higher levels of 'psychosocial' support than 'career-related' support
- neither mentoring forms were provided at high levels, possibly due to the infrequent contact between mentors and participants
- neither mentoring forms were significantly associated with profit.

However, the authors noted that caution is needed in concluding that mentoring does not contribute to business success as the relationship between mentoring and profitability of a new business was most likely to be 'confounded'.

Fostering collaboration through business incubators

Business 'incubators' (including 'accelerators' and 'hubs') are organisations that provide services that specifically support new businesses.[33] Services may include: office accommodation; office facilities such as telephone answering, facsimile and photocopy machines, computers and internet access, and the use of conference facilities; business and management services such as bookkeeping and accounting, entrepreneurial training courses, advice and assistance with business planning, and mentoring; financial assistance and capital raising; and advice on obtaining government assistance.

The general process of business 'incubation' has been described as follows:

> … a prospective tenant is interviewed for their suitability for business incubation and they move into an office or other space inside the incubator from which they operate their business. The business incubator provides assistance in the form of office service, management advice, mentoring, networking and general business assistance. The incubator may also be able to provide funding assistance to grow the venture. After a period of time … the business graduates from the incubator into the surrounding business economy. … And as one business graduates another new business take their space and thus the cycle begins again. (Kemp 2013, p. 28)

In the past, there was significant Australian government involvement in this area (Kemp 2013; Schaper and Lewer 2009). The first business incubators appeared in Australia in the 1980s and were funded by state and territory governments. The Australian Government then became involved in 1991 with the introduction of its Business Incubator Scheme, which supported the development of community-based, not-for-profit business incubators. This program was replaced in 1999 by the Building IT Strengths (BITS) Incubator Program, which sought to promote information and communications technology start-ups through technology business incubators. Following the closure of that program in 2008, Australian Government and other government involvement in business incubators generally subsided. Some business incubators (particularly those established by universities) continue to be assisted through public funding (table 11.3).[34] Box 11.3 provides examples of international approaches to public funding of business incubators.

[33] The Commission uses the term 'business incubator' in a broad sense. It notes, however, that some commentators (ATP Innovations 2015; Hub Australia 2014; Ruehl 2013; Treadgold 2014) distinguish 'business incubators' from 'accelerators' and 'hubs'. In these articles, *business incubators* are seen as providing services that help businesses start up 'from scratch'. Services include physical office space, information and advice, mentoring, and skills and training. They tend to provide long-term programs. *Accelerators* provide similar services to that of incubators, but focus on businesses that are past the very early start up stage. They are geared towards ensuring the business is able to compete and grow. They may provide seed funding in exchange for equity in the business. They tend to provide short term programs of 3 to 6 months. *Hubs* are largely physical locations where new businesses are able to share office space and facilities. As in incubators and accelerators, they may also offer other services such as information and advice.

[34] The Australian Government also had a 'Building Entrepreneurship in Small Business' program from 2005 to 2012 to provide incubation services to small businesses.

Table 11.3 Government and university assistance through business incubators

Assistance measure or program	*Description*	*Objective*
ATP Innovations (4 NSW universities)	Supports new businesses with providing access to office space, laboratories, guidance and mentoring, capital assistance and a professional network.	To help technology-based start-ups and entrepreneurs grow, achieve success and find investment. To create a supportive entrepreneurial ecosystem where innovation can thrive.
Business Enterprise Centre Darwin (NT and Australian Governments)	Provides free business training, advice and referrals to providers of practical advice.	To foster the establishment and development of successful new businesses in the Northern Territory
New Ventures Institute (Flinders University, SA)	Hosts an incubator and co-working space in Adelaide.	To create and foster an entrepreneurial community in Adelaide.
Startup Queensland (Qld Government)	Provides funding of up to 50 per cent of the total eligibility activity costs (up to a maximum of $25 000) to Queensland-based organisations to deliver practical information, advice and networking opportunities, collaboration, connectivity and transformation entrepreneurship to the Queensland start-up community.	To achieve a goal for the Queensland start-up sector to contribute 4 per cent of gross state product by 2033, thereby injecting $20 billion and 100 000 new jobs into the Queensland economy.
Tasmanian Technopark (Tas Government)	Provides assistance to start-up and existing businesses to accelerate growth, facilitate strategic alliances, encourage information dissemination and technology transfer with other organisations. It also offers accommodation options to suit a range of businesses — from complete, self-contained, client-owned buildings to leased accommodation including a business incubator.	To encourage growth in technology and innovation-based industry in Tasmania by fostering a culture of innovation and helping tenants to commercialise innovative products and services.
Young Enterpreneur Spark Program[a] (SA Government)	Supports first time entrepreneurs to start-up a new business through cross-sector and cross-generational collaboration. Runs for 4 months and gives participants full-time access to Hub Adelaide, a mentor and community network of business leaders, and a platform to promote and launch their ideas.	To accelerate growth, facilitate strategic alliances and to encourage information dissemination and technology transfer with other organisations.

[a] In partnership with Hub Adelaide.

Source: ATP Innovations (2015); Australian Government (nd); BECNT (2015); Department of State Growth (2014); DSITIA (2015b); NVI Flinders (2014)

Box 11.3 **International approaches to business incubators**

- The Chinese Government established tech start-up incubators in 1987 under its Torch Program — the world's largest program supporting technology entrepreneurialism. China now has over 1000 start-up incubators that together support around 60 000 start-ups.
- The Israeli Government established the Technological Incubators Program in 1991. Each company in the program receives between A$500 000 and A$880 000 in government funding through a grant repayable as royalty on sales. The Program has helped launch 1700 companies with total government investment of A$760 million. Of these 'graduates', 60 per cent have successfully attracted private investment with total private investment of A$3.9 million. The Government invests A$50 million per annum through the Program, equating to 85 per cent of the incubators budgets.
- The New Zealand Government has an Incubator Support Program consisting of a national network of government funded start-up incubators that may provide grants of up to A$425 000 per start-up.
- The Singapore Government's Technology Incubation Scheme is a network of 14 tech start-up incubators established in 2008. It is modelled on the Israeli incubator program. Companies in the incubator network are able to access co-funding investments from the government of up to $550 000 on the recommendation of an incubator.
- In the United States, start-up business incubators have been prevalent for over 50 years with 1400 currently in operation. The vast majority of business incubators (94 per cent) are not-for-profit entities who receive 52 per cent of their funding from government and economic development agencies, with a further 20 per cent from universities.

Source: StartupAUS (2015)

Today's business incubators in Australia comprise a mix of organisations offering a diversity of services. Most are not-for-profit organisations (such as 'business enterprise centres') that have been previously supported by, or at least have strong affiliations with governments and universities (BIIA, pers. comm 4 May 2015; Kemp 2013, pp. 32–33; Schaper and Lewer 2009, p. 42).

Business Innovation and Incubation Australia has registered 44 not-for-profit business incubators of which about 11 are business enterprise centres. The main sources of funding of these incubators are fee for service, although governments continue to support them through property or peppercorn rent agreements as well as providing opportunities to tender for various business development programs.

There has also been an emergence of university and commercially-operated business incubators in recent years (for example, Kemp 2013, pp. 32–33). Although it is difficult to accurately gauge the numbers of these, the Fetch Blog (2015b) lists around 25 private sector start-up 'business incubators and accelerators' around Australia (box 11.4). Many on the list seek to support early stage tech start-ups and are based in Sydney and Melbourne. While some offer funding in return for equity in the new business, most offer support through mentors, office space and facilities, workshops, and access to networks. The Fetch Blog (2015a) also lists another 100 co-working spaces offered by the private sector in all states and territories, mainly in the capital cities. With commercially-operated incubators, the 'assisting' business appears to benefit from providing services to the start-up through the acquisition of equity (for example) and the capturing of benefits (including positive spillovers) for their own business such as rental income and spillovers from collaboration, networking and physical co-location.

Box 11.4 Examples of private sector business incubators in Australia

- BlueChilli partners with entrepreneurs to help build, grow and invest in their new tech start-up businesses. It offers: a 'digital agency' service involving a product team that works with individuals to get a tech start-up business 'off the ground'; an 'incubator' service which involves a 'safe environment' to build a start-up supported by other entrepreneurs, an advisory team, office space, meeting rooms and events, shared services; an 'accelerator' service which teaches individuals how to run and prepare a start-up for capital raising, and a venture capital fund that co-invests in specific start-ups.
- NRMA and Slingshot launched Jumpstart, a new 'accelerator' program that seeks to support 'smart services, connected cars, connected members and member lifestyle startups' The program takes on 10 start-ups and offers $30 000 in seed funding in exchange for 10 per cent equity, potential access to NRMA members, and workspace at hubs in either Sydney or Newcastle. In addition, the program takes on four 'scale up' start-ups, businesses which may have already secured investment and may not be looking to give away equity to raise money, but are interested in entering a mutually beneficial arrangement with NRMA.
- NAB provides a space at its office in Bourke Street Melbourne called 'The Village' for over 1000 SMEs, suppliers or partners. Members can use The Village for work meetings, to collaborate and to learn from NAB experts through regular events.

Source: BlueChilli (2015); NAB (sub. 7, p. 5); White (2014).

Many Australian commentators have focused on the (often) beneficial outcomes of governments funding business incubators in terms of the number of start-ups they have launched as well as other economic impacts, particularly on employment. For example:

- Google Australia (sub. 37, p. 9) noted a study by the US Department of Commerce Economic Development that found that for every $10 000 of US government funding invested in business incubators (including non-tech businesses) between 46 to 69 local jobs were created, roughly 20 times more than created by infrastructure spending.
- Business Innovation and Incubation Australia estimated that — based on AusIndustry data that business incubators graduated 3500 businesses and assuming an annual turnover of $250 000 per graduate business — incubators 'facilitated more than $875 million in [small to medium enterprise] sales' (BIIA 2008, p. 5).
- An evaluation of the Australian Government's BITS Incubator and Intelligent Island Incubator Programs by the Allen Consulting Group (2003) found that the programs have performed well in meeting program objectives. In particular, the programs enabled 'hundreds' of start-up ICT managers to start and/or grow their business to the point of achieving self-sustaining growth in revenues, while also creating a pool of skilled individuals (2003, finding 7). That said, the evaluation also found that, without a

> further period of assistance, ‘it is probably that most Incubators will not be viable and a number of promising Incubatees currently receiving assistance will fail’ (2003, finding 10)

Should governments support business incubators?

The case for government assistance to business incubators rests on a mixture of rationales. It is not just about promoting entrepreneurialism per se, but also about addressing market failures (information problems and beneficial spillovers), promoting industry development and employment, and promoting small businesses (including addressing concerns about failure rates).

For example, the stated objective of the Australian Government’s previous BITS Incubator Program was to make a ‘significant contribution to the national innovation system by’:

- identifying and supporting high potential ICT start-ups;
- facilitating growth in employment, revenue and exports for the ICT start-ups;
- assisting these ICT start-ups to secure financial and other support from third party sources (including venture capital firms, private investors, other technology firms, universities and government);
- establishing mutually beneficial linkages with other elements of the Australian innovation system; and
- adopting strategies to achieve ongoing financial self-reliance without further Australian Government support beyond the period of the program extension. (AusIndustry nd)

In relation to its Building Entrepreneurship in Small Business, the Australian Government said that:

> [Small business] incubators are known to reduce the failure rate of new start-up businesses. In doing so they create jobs and assist local economic development. (AusIndustry 2003 cited in Kemp 2013, p. 18)

However, the net benefits of governments supporting business incubators are not always clear. For example, Bhabra (2014, p. 1) noted that, despite their popularity around the world, there is ‘still uncertainty about whether incubators are achieving their goals, and exactly what their impact is on the businesses that they house’.

This uncertainty is apparent in relation to the Australia Government’s BITS Incubator Program. Although the Allen Consulting Group (2003) highlighted positive outcomes, other commentators expressed concern. For example, Lerner (2010, p. 6) considered that the incubators taking part in the program, ‘frequently captured the lions’ share of the subsidies aimed towards entrepreneurs, by forcing the young firms to purchase their own overpriced services’. Kemp (2013, p. 32) considered that one of the ‘critical factors’ explaining the demise of the Australian Government’s BITS Incubator Program was the 'burn rate' of government funding by incubators, without replacement income being generated from the 'incubated' businesses.

> In effect, a small intermediary industry sprung up to 'facilitate' the spending of government funds, which comprised of opportunistic organisations with sufficient capacity and foresight to apply for these grants. While the individual businesses did receive some trickle down benefits, the big winners were the business incubation intermediaries. (2013, p. 32)

The Commission notes that government involvement in business incubators is not as significant as it once was and is currently very limited. Those business incubators that are likely to be successful and enduring will develop and grow organically, as a result of locational advantages (such as low cost capital, proximity to infrastructure or highly skilled labour), regardless of initial funding sources, and are persistent and adaptive. Given the emergence of commercially-operated business incubators (as well as co-working spaces and hubs), governments should review their remaining funding in this space to avoid displacing or duplicating private sector activity.

Financial assistance

There is a plethora of government financial assistance programs that are relevant to the set-up, transfer and closure of new businesses. They include grants and subsidies, concessional loans, tax concessions, and venture capital assistance.

Financial assistance is provided to help with a range of costs including business set up costs, or to fund the development of new products and services. Often financial assistance is provided to overcome perceived obstacles to accessing finance, including a lack of security on the part of the business owner, or risk aversion on the part of traditional financiers.

Financial assistance may be specific to particular industries, locations (for example, rural and regional areas or particular cities), types of businesses, and groups within the community. Assistance may also be focused on a particular business activity such as the commercialisation of research and development or expansion into export markets.

Examples include: City of Melbourne and Frankston City grants (table 11.4), financial assistance to Indigenous people under the Northern Territory Government's Indigenous Business Development Program (table 11.5), the Australian Government's Export Market Development Grants Scheme, and the Australian Government's Entrepreneurs Infrastructure Programme – Accelerating Commercialisation (see table 11.7).

Table 11.4 **Industry and location specific government assistance**

Assistance measure or program	*Description*	*Objective*
Canberra Business Development Fund (ACT Government)	Provides eligible businesses located in the Canberra region with a source of capital funds through equity investment.	To provides significant growth benefits for investee companies including the injection of high-level management skills, the capacity to leverage additional private sector capital, access to Commonwealth funds and grants, and quality employment growth.
City of Melbourne grants	Offers grants of up to $30 000 to small businesses located or intending to locate to Melbourne to help start-ups of 'new and creative' businesses'.	To encourage new, creative and diverse business activities that contribute to a thriving and competitive business environment within the city. To encourage city-based businesses to engage in and expand their export activities.
City of Perth grants	Offers grants of up to $2000 to small businesses located or based within Perth to purchase new equipment, with start-up or expansion costs or for other approved projects.	Not stated.
Early Stage Development (Screen NSW, (NSW Government)	Provides support during the early stage of a screen entertainment projects life, with both investment and feedback. Offers investment in the materials of early development. Funding for business consultants and the writing of business plans for screen content companies.	To fund the development of feature films, television drama and narrative comedy, content-rich factual and documentary television or web programs and series, animation series, and creative interactive screen entertainment.
Frankston City grants	Offers up to $15 000 for start-ups.	To create employment, activate commercial precincts, shift perceptions of the municipality, build a resilient local economy, attract innovative enterprises.
Industries for Today and Tomorrow (Vic Government)	Facilitates the development of regionally-based businesses with high growth potential and encourages new industry investment in regional locations.	To support activity that addresses: business growth through new investment, adoption of new technology and innovation; market development; and regional industry skills.
Skilled Regional Relocation Incentive (NSW Government)	Helps individuals relocate from metropolitan to regional areas for the purpose of self-employment or purchasing a small regional business.	To attract people to commence working in a regional job or start a regional small business.

Source: Australian Government (nd)

Table 11.5 **Government assistance to particular groups in the community**

Assistance measure or program	*Description*	*Objective*	*Main relevance to set-up (S), transfer (T), or closure (C)*
Business Development and Assistance Program (Indigenous Business Australia)	Provides support, funding and loans for Indigenous people looking to start or grow a small to medium business.	To promote and encourage Aboriginal And Torres Strait Islander self-management and economic self-sufficiency.[a]	S, T, C
Indigenous Business Development Program (NT Government)	Provides financial assistance to Indigenous people to enter commercial businesses or expand existing businesses.	To develop employment and income opportunities.	S
Indigenous Employment Programme (Australian Government)	Assists Indigenous Australians that have viable business ideas to start their own business. build skills to run and grow that business, and also help Indigenous organisations, business owners, communities and family groups at any stage during the lifecycle of the business.	To increase the employment outcomes and participation in economic activities for Aboriginal and Torres Strait Islander people.	S, T, C
New Enterprise Incentive Scheme (Australian Government)	Provides accredited small business training, advice and mentoring for eligible job seeks for up to 52 weeks, as well as ongoing income support for up to 39 weeks.	To support a successful and viable small business at the end of participant's participation.	S
SA Young Entrepreneurs Scheme (SA Government)	Assists young South Australians aged 18 to 35 years to develop and implement their business ideas through providing a business mentor and workshops.	Not stated.	S
Social Enterprise Development and Investment Funds (Australian Government)	Offers finance and support to eligible social enterprises. Finance is offered through three fund managers.	To help social enterprises grow their business and increase the impact of their work in their communities.	S
Social Enterprise Fund – Grants Program (WA Government)	Provides grants to new and existing social enterprises as well as a support service, through a consortium of not-for-profit organisations, including pre-investment support and after care support.	To increase the number, effectiveness and efficiency of social enterprises in Western Australia by supporting not-for-profit community sector organisations to establish new or strengthen existing social enterprises.	S

[a] Objective of Indigenous Business Australia, not the program.

Source: Australian Government (nd); Department of Local Government and Communities (2014); IBA (2014)

11.2 Rationales for government assistance

As discussed above, government assistance related to business set-up is provided for a range of reasons. Sometimes assistance is intended to address a specific market failure or gap (such as the existence of information problems or to generate beneficial spillovers, box 11.5). In these cases, government support is argued to deliver improved economic or social outcomes, relative to that which would be achieved by the market alone. In this vein, there has been a growing focus on governments — in Australian and overseas — providing assistance for encouraging and enabling entrepreneurialism, and targeting high growth and technology-based businesses. The argument being that knowledge spillovers, network and learning effects benefit other businesses and the wider community and generate a virtuous cycle of investment and employment growth. For similar reasons, governments have long supported 'small' businesses, because of their perceived contribution to employment and productivity, as well as concerns that they face barriers to set-up that are specific to size.

Governments also seek to facilitate economic development or structural adjustment in particular industries or locations; and to promote business set-up and ownership as a means of addressing social goals, in particular the creation of employment and income generating opportunities for disadvantaged communities and individuals.

Box 11.5 **Market failures**

Information problems

When there is a lack of information, an imbalance or bias in available information (so-called information asymmetries), or information is very costly to obtain, then markets can 'fail' to operate effectively. For example, an individual seeking to set-up a business may: find it difficult to access finance because the lending institution has no objective information about the business owner or their new product or service; or face substantial costs in acquiring relevant information about markets, demand for products or services, cost structures, the characteristics of existing or potential competitors, and regulatory requirements.

Markets often find ways of limiting the impact of information problems without government intervention such as through: the Internet, which has enabled widespread 'free' dissemination of information and advice; commercially available information and advisory services; or membership of industry associations.

Missing markets

Markets are described as 'missing' when demand (or supply) for a product or service exists but there is no corresponding supply (or demand) for that product or service. Within the context of business set-up, transfer and closure, for example:

- an individual in a rural or remote location may be unable to sell their business because there are no buyers at any price

(continued next page)

Box 11.5 **(continued)**

- there may be an absence of a market providing finance to individuals seeking to set-up a small business or high risk business venture (Lattimore et al. 1998)
- an individual seeking to set-up a business in a remote community may be unable to do so due to an absence of banking services in that community (Altman 2002).

A common reason for missing markets is information problems. For example, there may be a lack of information about businesses for sale in a remote location and so no buyers are forthcoming.

Spillovers

Spillovers (externalities) occur where individuals or businesses do not incur all the costs or receive all the benefits of their activities; some of these costs or benefits are borne by other parties.

Positive spillovers may result from *research and development, innovation and other knowledge generating activities*. Other individuals or businesses may acquire the benefits from that new knowledge without paying for it (for example, through reverse engineering or information contained in patents) and/or benefit from the demonstration effects of seeing how a new business model or product is received in the market. This can deter or delay those who initially generated the knowledge from proceeding or investing further — for example, by setting up a new business — as they are not able to capture the full benefits (Lattimore et al. 1998).

Collaborations, networks or the mere physical co-location of individuals or businesses may also result in positive spillovers such as the sharing of ideas and other resources that launch new businesses. The existence of these positive spillovers has often been claimed in relation to entrepreneurial start-ups. For example, Lerner said ' … it is far easier being a start-up founder if there are ten other entrepreneurs nearby than if one is alone. In many respects, firm founders and venture capitalists benefit from their peers' (2010, p. 7).

As with information problems, markets appear to have found ways of capturing some of these beneficial spillovers — for example, through the private sector provision of certain types of 'business incubators' to promote start-ups.

Entrepreneurialism

The case for promoting entrepreneurialism (box 11.6) generally rests on two pillars: the role of entrepreneurs in driving innovation; and the role of innovation as a spur for economic growth.

As an example, in setting out its Industry Innovation and Competitiveness Agenda, the Australian Government stated that an ambition that Australia 'must pursue' is 'industry policy that fosters innovation and entrepreneurship':

> While established businesses that have already had commercial success will be vital to Australia's future, the Government understands the importance of encouraging entrepreneurship. Entrepreneurship and a flourishing start-up community promote job creation and productivity growth. These types of businesses benefit the broader economy by testing new ideas, developing new products and implementing new business models. Creating the

> conditions which encourage risk taking, entrepreneurship, investment and hard work is important to foster innovation in Australia. (2014c, p. iv)

Similarly, Australian commentators (PriceWaterhouseCoopers (PwC 2013); Silicon Beach Australia (nd); Small Enterprise Association of Australia & New Zealand (Mazzarol 2014a); StartupAUS (2015)) and participants in this inquiry (Google, sub. 37; Institute of Public Accountants, sub. 32) have emphasised the desirability of promoting entrepreneurialism and innovation.

Box 11.6 What is entrepreneurialism?

Entrepreneurialism has long been seen as a key feature of a free market. In the 18th and 19th centuries, the term was used to describe the bearing of risk to organise factors of production to deliver a good or service demanded by the market (Kukoc and Regan 2008).

Modern definitions starting with Schumpeter (1934) emphasise a strong link between entrepreneurialism and innovation (or risk), and distinguish entrepreneurialism from more simple forms of business management. As the Economist (2014) noted:

> Schumpeterians distinguish between ‘replicative’ entrepreneurs (who set up small businesses much like other small businesses) and ‘innovative’ entrepreneurs (who upset and disorganise the existing way of doing things.

In more recent years, it has been argued that entrepreneurialism represents an important link between R&D and economic growth as it facilitates the transfer of knowledge created in ‘incumbent organisations’ (such as academic and research institutions) to other organisations (for example, Audretsch 2007; Urbano and Aparicio 2015; Valliere and Peterson 2009; Wong, Ho and Autio 2005). This view sees entrepreneurialism as being a driving force of economic growth due to its role as a conduit of new knowledge and commercialism.

They claim that entrepreneurialism should — as in other countries (box 11.7) — be promoted through the creation of entrepreneurial or start-up ‘ecosystems’ or, otherwise, through particular measures. For example:

- StartupAUS (2015) identified a number of actions relevant to a ‘vibrant tech start-up ecosystem’ in Australia that involve: a pro-entrepreneurship culture; guidance from experienced entrepreneurs; a supportive regulatory environment; a collaborative business culture; visible successes and role models; risk tolerance; availability of capital; and technical skills (particularly in computer programming).
- SEEANZ (Mazzarol 2014a) considered that governments should focus on promoting entrepreneurial ecosystems (box 11.8) by fostering linkages between entrepreneurial businesses and other ‘actors’ (for example, customers, end users, suppliers and universities) to stimulate innovation.
- Google Australia considered government attention is required to address ‘weaknesses’ in that there is no national policy framework to support technology start-up or business incubators and that Australians are generally not taught entrepreneurial business skills at a younger age (sub. 37).

Box 11.7 International frameworks to promote entrepreneurialism

European Union

The Entrepreneurship 2020 Action Plan is a plan for EU member countries to better support entrepreneurs and high growth businesses. It emphasises the need to stimulate a culture of entrepreneurship and change public perception though entrepreneurship education. It includes measures such as: technology and entrepreneurship education programs beginning in primary school; the establishment of a European-wide entrepreneurship promotion campaign; the funding of a European network of start-up accelerators; the review of regulatory environments to ensure they are start-up friendly; amending tax legislation to stimulate 'angel' investment; establishment of a crowdfunding network; funding for a young entrepreneurs development program including international exchanges; measures to stimulate venture capital investment in start-ups; reduction of penalties and introduction of support services for 'honest' entrepreneurs who experience bankruptcy; establishment of a Europe-wide start-up mentors network; and a Startup Partnership based on the US Startup America Partnership.

Singapore

The Singapore Government has committed A$14 billion to its National Framework for Innovation and Enterprise to 2014. The aims of the Framework are to shift the country's economy from labour-driven to productivity-driven industries, and to support the creation and growth of at least five local technology companies with annual revenue of more than $1 billion. The vast range of measures under the Framework emphasise entrepreneurialism by way of education and provide practical and financial support to high growth, risk taking ventures.

United States

The US Government initiative Startup America Partnership is intended to accelerate high growth entrepreneurship through a partnership with start-up community leaders. Measures under the initiative are: expand access to capital for high growth start-ups by providing an extra A$2.2 billion in matching funds for venture capital and other private sector investors; expand entrepreneurship education and mentorship programs; strengthen communication of federally funded R&D; provide tax relief and incentives for start-ups; remove unnecessary regulatory barriers to high growth start-ups; introduce the Impact Investment and Early Stage Innovation program.

Source: StartupAUS (2015)

Box 11.8 Entrepreneurial ecosystems

Some commentators (Isenberg 2011; Mason and Brown 2013; Mazzarol 2014a) suggest that governments should focus on a more 'holistic' approach that supports 'entrepreneurial ecosystems' rather than focus on particular individuals, businesses or activities. An entrepreneurial ecosystem is the interaction that takes place between a range of institutional and individual stakeholders to foster entrepreneurship, innovation and small business growth.

According to this view, governments can support entrepreneurial ecosystems by being mindful of a number of general principles:

- You cannot create something from nothing — entrepreneurial ecosystems need to evolve from industries that already exist within a region or country.
- Policy approaches need to evolve over time — entrepreneurial ecosystems are complex and dynamic in nature and need to grow and develop organically and their evolution cannot be rushed by direct intervention.
- No one size fits all — every entrepreneurial ecosystem is unique and its size and shape will be determined by the local conditions at play within each of the components that comprise it.
- Government initiatives are likely to be ineffective in isolation — there are no 'magic bullets' that can be used to stimulate growth in an entrepreneurial ecosystem. Each component is of equal importance and, if any component is missing the system will fail or fail to grow.
- Entrepreneurial ecosystems require a 'top down' and 'bottom up' approach — both macro and micro-level policy settings need to be configured to help stimulate and sustain the growth of an entrepreneurial ecosystem.
- There is a need to distinguish between small business and entrepreneurs — most small businesses are not owned and operated by entrepreneurs. Although the majority of businesses are small businesses only a relatively small proportion is growth focused.
- Policies for high growth businesses should reflect their diversity — high growth businesses are not only found in high tech sectors. Further, their growth paths are seldom linear in nature, few high growth businesses are supported by venture capital and many grow through acquisition.

However, how government can encourage entrepreneurialism and enhance the benefits of it for the wider community is less definitive. As Josh Lerner from the Harvard Business School said:

> A two-sided picture frames the basic puzzle at work here. When we look at regions of the world that are, or are emerging as, the great hubs of entrepreneurial … activity in the world — places such as Silicon Valley, Singapore, Tel Aviv, Shanghai, Bangalore and Dubai — the stamp of the public sector is unmistakable. Enlightened government intervention played a key role in creating each of these regions. But for every effective government intervention, there have been dozens, even hundreds, of disappointments, where substantially public expenditures bore no fruit. (2010, p. 2)

Indeed, Lerner identified a number of conditions that governments should be mindful of to ensure that assistance directed at entrepreneurialism is cost-effective (box 11.9). Many of these conditions apply equally to government assistance in support of high growth businesses discussed later in this chapter.

Box 11.9 **Necessary conditions for government assistance to entrepreneurialism to be cost effective**

- Ensure the entrepreneurial environment is conducive to flows of information and investment funds as entrepreneurial activity does not happen in a vacuum.
- Recognise that entrepreneurial activity and its location are of interest to international investors; ensure strong global ties and avoid restricting international involvement; recognise the need for conformity to global standards.
- Recognise that time is needed for an initiative to bear fruit; do not expect the initiative to generate jobs growth in the short-term; do not focus on a particular stage of the entrepreneurial process.
- Ensure that assistance is an appropriate scale relative to the business/market; it should not be too small to be useless or swamp existing private sector activity; demand matching funds from credible private sector players; allow the market to provide direction on worthy investments.
- Beware of creating incentives that lead to problematic behaviour; create 'fire-walls' between elected officials and program administrators.
- Establish appropriate evaluation mechanisms that are transparent and close to those used by private sector in evaluating entrepreneurs and investments.
- Leverage the local academic, scientific and research base; make education a part of the mixture.
- Do not over-engineer or micro-manage entrepreneurship processes through requiring particular inputs.
- Recognise the need for creativity and flexibility in the programs that promote innovative and creative activity, including the need to end programs for successful activities that no longer need public funds.
- Do not blindly duplicate programs and incentives that worked elsewhere.
- Do not place stipulations on the allocation of investment funds to particular initiatives or fund pools; accept that a favourable tax policy is not a key driver of venture capital.

Source: Based on Lerner (2010)

The remainder of this section considers the promotion of entrepreneurialism through addressing cultural attitudes and entrepreneurial skills. Guidance on how governments can play a broader role in promoting entrepreneurialism is considered within the context of reform directions at the end of this chapter.

Cultural attitudes and entrepreneurial skills

A number of commentators have expressed concerns about Australia's cultural attitude to entrepreneurialism and the level of entrepreneurial education provided in schools and universities.

It is often claimed (for example, PwC 2013) that Australia has a reputation as a risk averse culture compared with other countries such as the United States, which is noted for its support for risk-taking and not penalising failure.

> [The Silicon Valley's] culture encouraged risk and accepted failure. … Not only was risk-taking glorified, but failure was socially accepted. There was a shared understanding that anyone could be a successful entrepreneur: there were no boundaries of age, status, or social stratum that precluded the possibility of a new beginning, and there was little embarrassment or shame associated with business failure. (Saxenian 1994, cited in Wood 2011, p. 9)

> I've built entire companies that have fallen over with millions of dollars of funding. That type of failure wouldn't have been tolerated in Australia. It's almost celebrated as a success in the US, like: 'Oh, you lost 5 million on that? Well that was a good warm up, let's go bigger next time' (Dr Saul Griffith, Australian expatriate inventor, cited in Cook 2011)

Concerns have been expressed that Australia's education system is not supporting the development of entrepreneurs, particularly at younger ages, by providing necessary entrepreneurial skills (for example, Google Australia, sub. 37) and being a barrier to innovation and creativity (Trowbridge 2013).[35]

International evidence suggests that, when compared to other countries with a similar culture and political system, Australia's performance against some specific entrepreneurial indicators on culture and education is mixed (for example, Acs, Szerb and Autio 2015; EO 2015; Singer, Amoros and Arreola 2015; WEF 2013). For example, according to the Global Entrepreneurship Monitor (GEM) 2014 (Singer, Amoros and Arreola 2015), while Australia's performance against the United Kingdom, the United States and Canada on certain cultural indicators (such as 'cultural and social norms') were broadly in line with them or better, Australia did not score as well on:

- perceptions of 'entrepreneurship as a good career choice' as a social value
- perceptions of 'high status to successful entrepreneurs' as a social value
- individual attitudes to 'fear of failure'
- primary, secondary and post secondary education for entrepreneurship (table 11.6).

This evidence raises a question about how important are entrepreneurial culture and education to new business set-up.

35 For example, a study commissioned by Adobe of 4000 educators and parents of students in primary, secondary and higher education from the United States, United Kingdom, Germany and Australia indicated that education systems did not invest enough in teaching creativity (Trowbridge 2013).

Table 11.6 Indicators of entrepreneurship

Global Entrepreneurship Monitor for Australia and comparable countries[a]

Indicator	*Australia*	*UK*	*US*	*Canada*
Perceptions of social values (per cent agree with statement)				
Entrepreneurship as a good career choice	53.4	60.3	64.7	57.2
High status to successful entrepreneurs	67.1	75.0	76.9	69.7
Media attention for entrepreneurship	72.6	58.4	75.8	67.7
Individual attributes (per cent agree with statement)				
Perceived opportunities	45.7	41.0	50.9	55.5
Perceived capabilities	46.8	46.4	53.3	49.0
Fear of failure	39.2	36.8	29.7	36.5
Entrepreneurial intentions[c]	10.0	6.9	12.1	12.0
Phases of entrepreneurial activity (per cent of population)				
Nascent entrepreneurship rate	7.6	6.3	9.7	7.9
New business ownership rate	5.7	4.5	4.3	5.6
Total early-stage entrepreneurial activity (TEA)	13.1	10.7	13.8	13.0
Established business ownership rate	9.8	6.5	6.9	9.4
Discontinuation of businesses (per cent of TEA)	3.9	1.9	4.0	4.2
Motivation for early stage entrepreneurial activity				
Necessity driven (per cent of TEA)	17.6	12.9	13.5	15.7
Opportunity driven (per cent of TEA)	81.5	83.6	81.5	76.3
Improvement driven opportunity (per cent of TEA)	63.8	52.7	66.9	63.3
Motivational index[d]	3.6	4.1	5.0	4.0
Entrepreneurship framework conditions (5 point Likert scale)[e]				
Entrepreneurial finance	2.34	2.77	2.99	3.10
Government policy (general)	1.83	2.90	2.69	2.50
Government policy (regulation)	2.44	2.33	2.33	2.85
Government entrepreneurship programs	2.23	2.62	2.61	2.86
Education for entrepreneurship (primary and secondary)	2.19	2.44	2.21	2.32
Education for entrepreneurship (post-secondary)	2.85	3.02	2.87	3.14
R&D transfer	2.18	2.20	2.64	2.57
Commercial and legal infrastructure for entrepreneurship	3.42	2.95	3.12	3.49
Internal market (dynamics)	3.03	3.28	3.30	2.31
Internal market (openness)	2.79	2.73	2.67	2.95
Physical infrastructure for entrepreneurship	3.91	3.54	3.98	4.28
Cultural and social norms	3.19	2.83	3.75	3.28

Denotes that Australia is the worst performer at the indicator. Denotes that Australia is the best performer at the indicator.
[a] Based on survey sample sizes of 2177 for Australia, 2007 for the United Kingdom, 3273 for the United States, and 2479 for Canada. [b] Relates to respondents who perceive good opportunities to start a business. [c] Relates to respondents who expect to start a business within three years and who is currently not involved in entrepreneurial activity. [d] Ratio between improvement driven opportunity and necessity driven motivation. [e] Scale ranges from 1 (the statement is completely false) to 5 (the statement is completely true).
Source: Singer et al. (2015)

Developing an entrepreneurial culture

The entrepreneurial culture of a community (or country) affects the attitude that individuals have towards entrepreneurialism, the likelihood of their choosing to be an entrepreneur as a career, their motivation to succeed and start again after failure, and the support given to setting up a business (OECD 2012b).

Few studies have directly measured the impact of a country's entrepreneurial culture on the set-up of new businesses. Those that have done so (for example, by examining the impact of variations in culture between regions of a country) found that culture plays a role in business formation, but this appears to be of less significance than the impact of 'structural' factors relating to the economy or the population (for example, Davidsson and Wiklund 1997 and Mueller and Goic 2002, cited in Bergmann 2009, pp. 62–63).

Other studies have found that individual attitudes (as distinct from broader cultural factors) — such as the assessment of one's own capabilities, the perception of opportunities for founding a business, and risk aversion or fear of failure to business formation — have a significant impact on business set-up (for example, Arenius and Minniti 2005, Koellinger, Minniti and Schade 2007, Lee, Wong and Ho 2004, cited in Bergmann 2009, p. 63). Moreover, some of these studies concluded that individual attitudes were less influenced by culture than by personality traits and structural factors (Bergmann 2009, p. 64).

Overall, this evidence suggests that while the culture of a country can contribute to business set-up, it is not the only, or indeed the most significant factor, with individual attitudes, economic and demographic factors also important. If there is a role for government in promoting entrepreneurialism, focusing on a community's entrepreneurial culture is at best only one consideration.

The making of an entrepreneur

Concerns about deficiencies in entrepreneurial education in Australia touch on an ongoing debate about whether entrepreneurs share certain personality traits; that they are 'born, not made' (Davidsson and Gordon 2013; Davidsson 2013b; Featherstone 2015).

Recent psychological research has found a relationship between personality traits and entrepreneurialism. For example, in their meta analysis, Rauch and Frese (2007, cited in Davidsson and Gordon 2013, p. 2) found that personality traits such as 'need for achievement', 'generalised self-efficacy', 'innovativeness', 'stress tolerance', 'need for autonomy' and 'proactive personality' were more pronounced among entrepreneurs than other people.

However, in his review of this and other psychological research, Davidsson considered that, although 'personality matters':

> … it is a mistake to think that it is *the* determining factor in any entrepreneurial process. [The] "failure" to find a typical, "must-have" personality profile sends a very, very positive message:

> a large majority of people are likely to be able to succeed in entrepreneurship under the right circumstances. A person who does not come across as a "natural born entrepreneur" can become a successful business founder when they work on an idea they are passionate about, and when they find their right role on an entrepreneurial team with complimentary competencies. Personality testing can only give marginal guidance for investors, and very few people have reason to think of themselves as "non-entrepreneurs" due to their personality. (2013b, p. 2)

That some entrepreneurial skills, like other skills, can be learned has been borne out by several studies, which found modest effects from entrepreneurial education and training on business formation and success. In their meta-analysis of 42 studies involving around 17 000 entrepreneurial cases, Martin et al. (2013) found a moderate improvement in entrepreneurial skills and outcomes, including starting and building a venture, following education or training. Fairlie et al. (2012) confirmed the positive effects of training on the propensity to start a business, but training had no measurable effect on the survival, growth or earnings of an enterprise. This suggests that entrepreneurial education and training can give a person the confidence to start a venture, but the benefits of that wear out over time. (Box 11.11 also sets out some studies of entrepreneurial education programs in schools and universities, which found beneficial outcomes relating to business set-up.)

This evidence suggests that, while entrepreneurs do share personality traits, some entrepreneurial skills can be learned, although the effects of such learning on business formation and success may at best be modest and very dependent on the content and delivery of the education and training program.

What can governments do to promote entrepreneurial skills

Key entrepreneurial skills are largely independent of the nature of the business activity and can include: business planning; general business skills such as marketing and bookkeeping; financial literacy; project management skills; entrepreneurial awareness and perceptions of opportunities; and socio-economic skills such as self-confidence, leadership, creativity, risk propensity, motivation and resilience (for example, see Valerio, Parton and Robb 2014).

Individuals can acquire these skills through direct 'on-the-job' experience, or through formal programs offered by schools, universities, industry associations and other organisations.

There have been calls for Australian governments (particularly the Australian Government) to further promote entrepreneurial skills by addressing entrepreneurial education and training in schools and universities. For example:

- Google Australia (sub. 37, p. 9) considered that governments need to give greater attention to ensuring that younger people are 'taught the skills they will need if they are going to establish successful businesses, such as financial literacy' and drew attention to examples of programs in Australian and US schools.

- StartupAUS drew attention to international examples (box 11.10) and recommended the implementation of a national program of entrepreneurship education in all schools and universities.
- Currently, the Australian education system is 'geared toward preparing students for the workforce. It does not adequately equip young people to start businesses, particularly high-growth start-ups'. (2014, p. 29)

Box 11.10 **International examples of government support for entrepreneurial programs in schools and universities**

Schools

- *Europe.* The European Commission is introducing education programs under which entrepreneurship will be embedded in the primary, secondary, vocational and higher education curriculum. There will also be an Entrepreneurship Day for students in their last year of secondary school, which includes meetings with entrepreneurs, case studies, lectures, workshops and company open days.
- *Singapore.* The Singapore Government's Young Entrepreneurs Scheme for Schools, provides schools with grants of up to A$90 000 to put in place structured entrepreneurial learning programs for their students.
- *United Kingdom.* The UK Government launched the Young Enterprise program in partnership with Virgin Money to develop primary and secondary students' business creation skills and attitudes by launching microbusinesses. There are plans to engage 40 000 children in 2016.

Universities

- *Europe*. The European Commission committed A$23 million to support development of entrepreneurship education programs to be delivered by way of business incubators (accelerators and hubs) aimed primarily at university students.
- *Singapore.* The Singapore Government funds the National University of Entrepreneurship Centre to provide experiential technology entrepreneurship education programs, annual entrepreneurship summer schools for foreign students, a New Venture Creation workshop for professions in the workforce, and a student accelerator program.

Source: Valerio et al. (2014)

In Australia, there are already a number of programs in schools and universities.

- School-based programs include Weekend (for schools), Startup Apprentice and Club Kidpreneur. These programs are generally funded by not-for-profit organisations and/or corporations, with some limited government support (Google Australia, sub. 37, p. 9; StartupAUS 2015, p. 41).
- Most universities have business schools that provide courses in entrepreneurship or small business management (Mazzarol 2014b, p. 6). Specific examples of university programs include the University of Sydney's Technology Venture Creation course and Flinders University's New Venture Institute. Some governments may provide targeted funding for these kinds of programs. For example, the South Australian Government co-funds

Venture Catalyst (with the University of South Australia), which seeks to encourage student entrepreneurship and the creation of local start-ups by providing up to $50 000 seed funding for early-stage ventures founded by students and recent graduates.

The rationales for governments support in this area largely reflect concerns about perceived deficiencies in entrepreneurial culture and entrepreneurial education and training. There are also said to be market failures such as information problems from individuals failing to recognise the value of entrepreneurial skills to entrepreneurial outcomes, as well as beneficial knowledge spillovers from individuals having entrepreneurial skills. As the World Bank noted:

> A government's rationale for playing a role in EET [entrepreneurial education and training] is tied to its interest in addressing mindsets, knowledge-based skills, and cultural constraints to entrepreneurship. … a government's role in EET is shaped by potential knowledge spillovers of entrepreneurial-related knowledge skills (across potential or practicing entrepreneurs in a certain area) as well as by evident market failures when individuals recognise the value of management expertise to their entrepreneurial outcomes. (Valerio, Parton and Robb 2014)

The Commission notes that a number of studies of entrepreneurial education and training programs in schools and universities have generally found modest beneficial outcomes, including in terms of affecting individual attitudes to, and the likelihood of, setting up a new business (box 11.11).[36] However, there do not appear to be any evaluations that have considered whether government spending in this area has delivered net benefits, or at least has been cost-effective. This view is broadly corroborated by Davidsson (2013a) who said that, although entrepreneurial skills can be learned, it does not necessarily mean that the value of the positive effects of that exceeds the cost of money invested.

While the Commission acknowledges that education and training is a necessary feature of promoting entrepreneurialism, entrepreneurial skills can be acquired in different ways, not just through schools and universities. If governments were to fund programs in schools and universities, they should ensure that their funding will significantly contribute to business set-up beyond what currently occurs under programs sponsored by not-for-profit organisations and the business community. They should also ensure there are no barriers to the private and not-for-profit sectors working with schools and universities to deliver programs.

[36] The World Bank (Valerio, Parton and Robb 2014) has undertaken a recent review of entrepreneurial education and training programs around the world.

Box 11.11 Studies of entrepreneurial programs in schools and universities

School programs

- A study of a Netherlands program called BizWorld for students aged 11 to 12 years found that the program had positive and significant effects on the development of non-cognitive skills (such as self-efficacy, the need for achievement, risk taking propensity, persistence, analysing, creativity and proactivity) among the students who received the program compared with those in the control group (Huber, Sloof and van Praag 2012, cited in Valerio, Parton and Robb 2014, p. 61). However, it also found positive, but not significant effects on cognitive entrepreneurial skills (entrepreneurial knowledge) and negative and significant effects on entrepreneurial intentions (to own a business). The study acknowledged that the measures used for entrepreneurial intentions were not validated for children and could potentially have affected the results.
- A study of the Swedish Junior Achievement Company Program, a not-for-profit program in high schools, found that participation increased the likelihood of starting a new business by at least 20 per cent when compared with the non-participants of the program. However, there was no significant effect on the survival of the business (Elert, Andersson and Wennberg 2013, cited in Valerio, Parton and Robb 2014, p. 200).
- An Australian study of the Young Achievement Australia Program, a not-for-profit program for secondary students, found that participants reported significantly higher perceptions of the desirability and feasibility of starting a business (Peterman and Kennedy 2003).

University programs

- Pittaway and Cope (2007) undertook a systematic review of studies on entrepreneurship education largely from the United States and the United Kingdom. They found that while there was evidence that university education in enterpreneurialism has a positive impact on student intentions to embark on entrepreneurial-related projects, there was little evidence to demonstrate actual performance post course completion.
- Elmuti, Khoury and Omran (2012, cited in Mazzarol 2014b, p. 9) examined the impact of university education in entrepreneurialism on 170 people in the United States who had either started or were embarking on a business start-up. They found that education enhanced their skills and business performance, in particular their attitudes towards the entrepreneurial process and their interpersonal social and technical skills. They suggested that while entrepreneurialism can be taught, it requires content based on case studies, application within real world projects, self reflection, and interactions between students.

High growth businesses

Internationally and in Australia there have been calls for governments to have a greater role in promoting high growth businesses ('gazelles') — particularly, those that use technology and innovation (known as 'high tech start-ups') (for example, in respect of Australia, see Google Australia, sub. 37, p. 9; PwC 2013; Silicon Beach Australia nd; StartupAUS 2015). In part, the focus by some on promoting entrepreneurialism is equivalent to promoting high growth and innovative businesses. A poor entrepreneurial culture is likely to weigh more heavily on the set-up of these businesses.

The benefits of high growth businesses include their economic contribution through job creation as well as the knowledge spillovers they generate, particularly through innovation. As the OECD said:

> The interest of policy makers for high-growth firms primarily stems from the contribution of this special segment of the business population to job creation. Empirical evidence has repeatedly shown that job creation is concentrated in a few exceptionally performing firms, while the largest majority of firms keep employment stable or shed jobs. … In addition to direct job creation, high-growth firms generate other benefits. They spark new demand for advanced products and services, which will benefit the local economy as whole; they produce knowledge spillovers which other nascent or existing enterprises can harness; and they strengthen the local entrepreneurial culture by acting as role models for future and nascent entrepreneurs. (2014b, p. 3)

Evidence of the benefits of high growth businesses have tended to focus on the extent to which they create jobs — particularly, that high growth businesses account for a disproportionate share of employment.

- Research commissioned by the UK National Endowment of Science, Technology and the Arts (NESTA 2009) found that 6 per cent of UK businesses with the highest growth rates generated half of the new jobs created by existing businesses between 2002 and 2008. The results of this research was confirmed in a later study (NESTA 2011).
- In their meta-analysis, Henreksen and Joahansson (2010, cited in OECD 2014b, p. 3) concluded that:

  > … a few rapidly growing firms generate a disproportionately large share of all net new jobs compared with non-high growth firms … and that this is particularly pronounced in recessions when gazelles (ie high growth firms) continue to grow.

- The Kauffmann Foundation (Kane 2010, cited in StartupAUS 2015, p. 11) found that new businesses added 3 million new jobs to the US economy each year and that 4 per cent of companies with the highest growth were responsible for 70 per cent of new jobs.
- Morretti (2012, cited in StartupAUS 2015, p. 11) found that for each new technology-based job in the United States, five additional jobs were created in other sectors.
- The OECD (2014a, pp. 70, 73) found from its examination of 24 member countries that, while few in numbers, high-growth businesses employed a considerable number of persons — for example, in France, some 15 000 high-growth businesses employed more than 1 million employees.
- PriceWaterhouseCoopers (PwC 2013) considered that the tech start-up sector in Australia has the potential to contribute 4 per cent of GDP and 540 000 jobs by 2033.

However, there is a need to go beyond the short term employment effects of high growth businesses, to consider the impacts of these businesses on overall long run employment, productivity and economic growth. For example, although supportive of the job creation benefits of high growth businesses, the National Endowment for Science, Technology and the Arts acknowledged that fast-growing innovative businesses:

> … can challenge and eventually replace weak incumbents. They are the engine of creative destruction, driving long-term productivity growth. (NESTA 2009, p. 3)

What can governments do to support high growth businesses?

Australian governments have introduced a number of measures that support the start-up of innovative or high growth businesses (table 11.7). Many of these measures are directed at innovation and other knowledge generating activities that may result in new start-ups, or to the development of particular 'growth' industries or businesses. Some of the measures are location specific, and some involve the use of business incubators.

The Commission has examined assistance to innovation and other knowledge creating activities in past studies on science and innovation, compulsory licensing of patents, and its 2012-13 annual review of trade and assistance (Banks 2011; PC 2007, 2013b, 2014g). Its general view is that there is a case for government assistance to particular knowledge generating activities based on promoting beneficial spillovers. However, this market failure rationale should not be regarded uncritically as *apparent* spillovers may be 'captured in surprising ways or may not adversely affect incentives to innovate by as much as formerly thought' (PC 2007, p. 73). The strongest case for government assistance addressing spillovers from knowledge generation by businesses occurs where they are engaged in novel R&D activities that either spill over at low cost to others or trigger cycles of innovation by rivals. However, spillovers at the commercialisation stage are likely to be fewer, which weakens the rationale for assistance directed at this end. Moreover, as there are large potential private returns to commercialisation, assistance risks supporting activities that would occur anyway.

Beyond targeting beneficial spillovers from knowledge creating activities, the Commission considers that governments need to be cautious in making judgements about the potential of high growth businesses.

- Based on a number of studies (Audretsch 2012; Mason and Brown 2013; NESTA 2009, 2011; OECD 2014b), it is not always easy to characterise high growth businesses. While most are of a young age and small in size, some high growth businesses are established and/or large. High growth businesses may also occur in both low and high tech sectors.
- Although some businesses may become high growth only with government assistance, other businesses may become high growth without assistance or may be unlikely to become high growth even under the most favourable of circumstances.

Rather than attempting to target specific businesses, industries or locations that may have the potential to be high growth in the future, governments should create a regulatory and business environment that is conducive to businesses becoming high growth.

Table 11.7 **Government assistance to new high growth businesses and/or innovation and other knowledge creation**

Assistance measure or program	*Description*	*Stated objective*
Business Innovation Support Initiatives (NT Government)	Assists NT-based and registered pre-start-ups, start-ups and microbusinesses to commence research and development projects in the areas of science, engineering, technology and design. Assistance is through vouchers or grants.	To assist Territory business people to commercialise the solutions they find to problems every day, knowing that innovation can be the driver for long-term success.
Entrepreneurs infrastructure Programme (Australian Government)	Research Connections helps small and medium businesses to collaborate with the research sector.	To develop new ideas with commercial potential, as well as help identify any knowledge gaps that are preventing business growth.
	Accelerating Commercialisation provides financial and other assistance to small and medium businesses and researchers (up to $250 000 for the commercialisation group of a research agency, and up to $1 million for a company).	To commercialise on novel products, processes and services.
Industry Growth Centres Initiative (Australian Government)	Establishes centres consisting of business and research organisations in five specific growth centres.	Among other things, encourage collaboration and the commercialisation of new products.
Industries for Today and Tomorrow (Vic Government)	Facilitates the development of regionally-based businesses with high growth potential and encourages new industry investment in regional locations.	To target businesses that make a major contribution to regional economic output.
InnovationConnect (Icon) - Accelerating Innovation Grants (ACT Government	Helps start-up and growth businesses with a feasible concept or service to enable participation in commercialisation, training, intellectual property strategies, marketing and mentoring processes. Offers grants from $5000 to $50 000 on a dollar for dollar matching basis. The program has 3 categories – proof of technology, accelerating innovation, and clean technology.	To help Canberra-based businesses develop innovative products and services.

Source: ACT Government (2015); Australian Government (nd); Department of Business (2015); RDV (2015)

Small businesses

Because most of Australia’s businesses are ‘small’ and most new businesses start small, small businesses feature prominently in calls for government assistance.

There are two rationales commonly claimed as the basis for government assistance to small businesses.

The first rationale focuses on the economic contribution of small businesses through, for example: helping maintain competition in many industries; innovative small businesses contributing to industry development, and generating jobs.

> Small business is the driver of Australia's economy, underpinning growth and innovation and providing jobs for millions Australians. … By unshackling the small business sector we will unleash the potential of small businesses to grow and create more jobs. (Liberal Party of Australia 2013)

> Thriving, innovative small and medium businesses are key to the Commonwealth Government's plan to build a secure, strong economy and create jobs. (Bilson 2015a)

Evidence given in support of this rationale often focuses on the share of small businesses in total businesses, and their contribution to employment and to value added. The vast majority of actively trading businesses in 2013-14 that start-up are small businesses (chapter 2). Small businesses (employing under 20 people) account for around 99 per cent of new actively trading businesses, 43 per cent of employment and 40 per cent of value-added in the private non-financial sector in 2012-13 (ABS 2014b, table 5).

The second rationale for government assistance to small business rests on their 'unique characteristics' that make them vulnerable to problems (including market failures) and may therefore result in business failure.

> The unique characteristics of small businesses influence the way they are run and their capacity to deal with issues that arise. Small businesses are not simply larger businesses scaled down. The vast majority of businesses in Australia, 61 per cent, are non-employing businesses. This means that most small business owners are required to be in a position to take decisions on all aspects of their business, from delivering goods and services, managing cash flow, business development, marketing and client management. … (The Treasury 2015a, p. 3)

> … small businesses face a unique set of operational challenges, and as a consequence typically have higher failure rates than those for larger companies. (Nicholls and Orsmond 2015, p. 1)

Examples and evidence of particular problems encountered by small businesses compared with larger businesses include:

- the difficulties and costs in acquiring information about government regulation and processes — the Commission (PC 2013e, p. 144) noted survey evidence from the Australian Chamber of Commerce and Industry that small businesses were twice as likely to find it more costly to find information about regulatory obligations than larger businesses
- regulatory compliance burdens — the Commission (PC 2013e, p. 68) reported research evidence of the disproportionate compliance burden experienced by small businesses compared with larger businesses
- deficiencies in business management skills (box 11.12)
- vulnerability to demand fluctuations — Nicholls and Orsmond (2015, p. 9) noted a wider distribution of revenue growth rates for small businesses compared with larger

businesses, which may be indicative of the relatively narrow geographic markets in which they operate and, hence, their sensitive to local demand conditions

- pricing, employment and investment plans — Nicholls and Orsmond (2015, p. 19) found that small businesses appeared to be less forward-looking in forming their pricing, employment and investment plans than larger businesses.

Box 11.12 **Deficiencies in small business management skills**

Running a viable business involves applying skills and knowledge to many aspects of the day-to-day management of a business as well as to long term strategic issues. The skills and knowledge to run a business are acquired in many ways — past and current training, on-the-job learning, mentoring, networks with other businesses, internal and hired expertise, and external advice.

In the case of small businesses, there are reported to be deficiencies in business management skills and knowledge in Australia. Recently, Nicholls and Orsmond (2015, p. 10) noted anecdotal evidence that owner-managers can be reluctant to improve their company's performance by hiring a professional manager in a timely manner to free up their time to return to their original trade and expertise. They also noted data that showed that, of the small business failures that fall into corporate administration, managerial issues were the most commonly cited cause.

A deficit in business management skills and knowledge has often been the basis for suggestions for further management training for small businesses. However, Lattimore et al. (1998, p. 56) noted empirical evidence available at the time was not conclusive about a link between business success and a business operator's training even though it would be expected that up to a certain point there were likely to be positive results.

Even if there were a strong link between management training and business performance, this is not necessarily grounds for further government intervention. It may be that mainly successful businesses can afford to fund management training in which case causality can run both ways. Also, there may be self-selection in management training whereby people choose to undertake training and it is that, rather than the training itself, that has the biggest impact on business performance.

More broadly, deficiencies in business management skills may not necessarily be a unique problem for small businesses. ABS data indicate that 4.7 per cent of very large businesses (employing 200 or more persons) experience skills shortages or deficiencies in business management compared with between 3.1 and 4.2 per cent of smaller businesses (employing fewer than 20 persons) (ABS 2014g, Skills Data Cube).

What can governments do to support small businesses?

The large number and churn of small businesses and their characteristics provide good reasons for governments to keep small businesses in mind when developing government assistance programs and regulations. It is particularly important that governments ensure they contain regulatory compliance burdens on small businesses.

However, as Lattimore et al. (1998, p. 56) noted, these rationales are not, of themselves, strong grounds for governments to specifically assist small businesses. For example,:

- Small and large businesses set-up and develop in response to a range of factors such as the technology used in different industries and customer preferences in relation to the quality of service and other features. Any government assistance to small (or large) businesses without sound rationale other than their size will affect the incentives facing the people who establish the businesses and so create costs resulting from distorted choices.
- Providing assistance on the basis that small businesses collectively employ many people or have a substantial share of economic activity is a fairly arbitrary focus. It could equally be argued that a few large businesses are collectively responsible for a large share of employment, production and exports, are more productive and more involved in innovative activities than small businesses.[37]
- There is a large degree of heterogeneity among small businesses. They can differ in terms of their levels of technology, the skills of their workforces, and their capacity to seek information and advice, as well as in perceptions of the challenges they face (for example Holmes and Gupta 2015b). This indicates that there is a diversity of their needs for assistance and, thus, challenges in designing assistance programs that would cost-effectively assist them.
- The problems facing small businesses are not necessarily unique to them and can be experienced by larger businesses — this seems to apply to management skills where ABS data indicate that very large businesses experience more skills shortages or deficiencies in business management than smaller businesses (box 11.12).
- It is important to consider the nature of the risk of business failure for small businesses and how this compares with larger businesses. In some industries (for example, retail and hospitality industries) there may be a greater likelihood of an adverse event arising for a small business, but the magnitude of that harm (and therefore the consequences for business failure to result) may be relatively low.

Accordingly, the rationales for small business assistance — particularly, the 'unique' characteristics of small businesses — require careful consideration of the evidence on a case by case basis.

[37] An estimated 1 per cent of small businesses employing fewer than 20 people introduced an innovative good or service that was 'new to Australia' compared with 14 per cent of large businesses with 200 persons or more (Commission estimates based on ABS 2013b, 2015c). See also, Soames et al. (2011) who using the ABS Business Longitudinal Database, estimated that larger businesses were more likely to be innovative than smaller businesses.

Other rationales

The Commission has examined industry and location specific assistance extensively in past studies (for example, Banks 2011; PC 2008b, 2009c, 2012b, 2013d, 2014b, 2014g). Its general view is that while assistance can stimulate economic activity and employment in a particular industry or location, it usually comes at a cost elsewhere in the community. It can also reduce incentives for assisted businesses to compete vigorously and reduce costs and induce rent-seeking behaviour by other businesses seeking similar treatment. The structural adjustment rationale for assistance is much stronger (but only on a temporary basis) for workers than for businesses; unlike businesses, workers cannot readily diversify risks and are poorly informed about such risks when making employment decisions.

Governments also seek to promote social goals by supporting the set up (or transfer and closure) of businesses:

- by specific groups of people — such as Indigenous people, young people, the unemployed and people with disability — who may generally be seen as experiencing economic disadvantage or other difficulties, or for whom greater economic independence is desired
- that are social enterprises, which are commercially viable businesses that exist primarily to benefit the community, rather than their shareholders and owners.

Assistance directed at social goals may also involve addressing other rationales, including market failures such as relating to information problems. The Commission considers it important that the goals are clearly articulated and underpinned by evidence of the extent of the problems that they reflect. Measures used to address social goals should also strive to impose minimum costs on the wider community.

11.3 Reform directions

Government assistance for business is less effective in the face of broader, persistent regulatory impediments. Before considering the implementation of specific assistance programs for business, governments should first ensure that they have addressed existing regulatory and tax barriers to investment and competition, many of which are detailed in this report and have been previously addressed by the Commission.

An important risk for governments in providing assistance for business set-up is that they will support activities or provide services that would have occurred anyway, and/or that they will distort underlying market signals in a way that produces a less optimal or efficient outcome, contrary to the stated policy objective.

To counter these risks and to ensure that government programs in support of business set-up are effective, all government assistance should be subject to transparent development processes that incorporate clear and credible objectives, an assessment of likely community-wide net benefits (including spillover benefits), and evidence that the market would fail to deliver the desired good or service in the absence of government involvement (box 11.13).

Box 11.13 A framework for allocating government assistance

From a community-wide perspective, the process that governments follow for allocating taxpayer funds to assist individuals and businesses should consist of the following steps:

First, governments should examine the following **threshold questions** with respect to an assistance program: What is the rationale for government assistance? Is there a market failure, including for example positive spillovers (market failure test)? Are there social goals? Would government assistance achieve the rationale (effectiveness) and result in benefits that would not otherwise be captured if left to the market (additionality test)? Would government assistance result in benefits that exceed the costs compared with alternative options (net community benefit test)?

Second, where governments are satisfied that by answering these threshold questions there is a sound policy rationale for assistance, it should apply **operational practices** to ensure on an ongoing basis that the government assistance program achieves its rationale. These practices involve identifying measurable objectives, setting performance indicators, and monitoring and reporting performance indicators against objectives.

The third step involves **independent and transparent evaluation**. This examines the impacts of the government assistance program, whether the rationale for it has been met, and the scope for improvement including whether the program should continue.

Although evaluating each and every assistance program relevant to business set-up, transfer and closure is beyond the scope of this inquiry, the Commission has identified a number of specific areas of government assistance that warrant priority attention.

- There appears to be a proliferation of government assistance through information and advice on commercial matters as well as through mentoring, skills and training to individuals and businesses, with no apparent publicly available evaluation of relevant programs. Governments should examine their continued funding and provision of these services, particularly where the information and advice can be sourced from the private sector.
- Given the emergence of private sector business incubators, governments should review their assistance in this area.
- The use of assistance by some Australian governments to compete with other governments to attract new businesses into their jurisdictions is a concern. Although it may benefit the particular jurisdiction in question, it encourages new businesses to make locational decisions which can result in inefficiencies. This type of assistance should be removed.
- Government assistance to facilitate structural adjustment can deter inefficient businesses from exiting. In the case of new structural adjustment assistance, it should be made temporary. Where it has been provided on an ongoing basis, it should be phased out and eventually removed. Governments should review this type of assistance.

- The potential for knowledge and network spillover benefits associated with business activity should be prudently considered and evaluated. The Commission has previously concluded that there is a case for government assistance to particular knowledge generating activities based on promoting beneficial spillovers. But, it has also noted that this rationale should not be adopted uncritically as benefits that appear to be spillovers may in fact be able to be captured by those generating them or that there may still be incentives to innovate.

DRAFT RECOMMENDATION 11.1

All governments should give priority attention to:

- providing information and assistance on commercial matters, and through mentoring, skills and training, only where a market failure in private provision is clearly demonstrated
- reviewing assistance to business incubators
- removing assistance that is intended to attract new businesses to their jurisdiction
- reviewing structural adjustment assistance.

Entrepreneurialism is an important feature of markets and results in beneficial outcomes for the whole community, particularly in terms of innovation and economic growth. If governments provide any assistance to promote entrepreneurialism, they should adhere to the governance framework set out in box 11.13. They should also ensure that other conditions are met to support the cost-effectiveness of any assistance (see box 11.9) — in particular, that the assistance:

- targets directly market failures that are barriers to entrepreneurialism (and other types of businesses), including knowledge generating activities that are likely to result in substantial positive spillovers
- is of a scale that is in keeping with the size of the business or market
- involves matching commitment from businesses
- is subject to appropriate evaluation.

Governments should also take care not to 'pick winners' by focusing on specific business models, high growth businesses, industries, or locations. This approach can draw resources away from other activities or locations that may be just as, or more, worthwhile from a community-wide perspective.

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All government assistance programs for business should be of fixed duration, subject to transparent assessment of the economy-wide net benefits, and incorporate clear and credible objectives, performance indicators and independent evaluation.

Any promotion of entrepreneurialism by governments should:

- **target desired outcomes and community benefits, such as knowledge or network spillovers and technology transfers resulting from innovations (rather than prescribing specific business models, sectors or locations)**
- **be modest, relative to the scale of the business or market**
- **require matching private sector funds or support where possible, and**
- **embed frequent assessments to enable early learnings and necessary program evolution or program end.**

Some participants have been critical about the red tape around the administration of grants. For example, Future Perspective noted that 'grant administration red tape' remains problematic for entrepreneurs and impeded 'real business innovation' (sub. 17, p. 3). It expressed concerns about: the cancellation of grant programs without imminent replacement and/or policy certainty; and ongoing challenges — for example, uncertainty of outcomes, significant time delays in decision making, and the quantity and type of grants related paperwork.

Governments should provide accessible information about all their regulations, processes and programs. As discussed earlier, government information portals can help to signpost individuals and businesses as to where to find this information.

In setting information requirements for applications for assistance, governments should be cognisant of imposing undue compliance burdens on businesses while ensuring that they satisfy accountability concerns (for example, as to the probity of applicants seeking assistance). Similar concerns have been raised about the compliance burdens on businesses imposed by government procurement processes (chapter 10). Solutions there have involved simplified forms for small businesses and electronic lodgement — these solutions could also apply in respect of assistance applications.

12 Voluntary business exits

Key points

- The vast majority of business exits are voluntary. Over 90 per cent of business exits are not the result of formal insolvency, indeed some are an indication of success.
- Businesses choose to exit for a range of reasons. Pathways for voluntary exit include family succession, sale of business, merger, transfer to employees, management buyout, initial public offering, private placement and cessation.
- Depending on the legal structure of the business, a number of processes must be completed when a business is closed or transferred to a new owner. These include transferring or cancelling the business name; finalising tax obligations; fulfilling obligations to employees and suppliers; cancelling or transferring any business licences, permits and registrations; and if necessary taking out run-off insurance cover; dissolving partnerships and deregistering companies or trusts.
  - For sole traders and partnerships, exit is usually a relatively straightforward process. However, larger companies with complex operations or ownership structures may take several years to deregister.
  - Dealing with employee requirements under the *Fair Work Act 2009* (Cth) was noted by stakeholders as complex and time consuming. The performance of the Workplace Relations Framework including the *Fair Work Act 2009* (Cth) is the focus of a separate inquiry currently being undertaken by the Productivity Commission.
- The impact of mergers and acquisitions on competition is assessed by the ACCC under the *Competition and Consumer Act 2010* (Cth) which prohibits business transfers that would have the effect, or likely effect, of substantially lessening competition in any market.
  - In line with the 2015 Harper Review, the ACCC should implement more streamlined formal merger exemption processes which remove unnecessary requirements and improve the efficiency and effectiveness of business transfer processes.
- The burden of capital gains tax (CGT) and the complexity of small business CGT concessions may influence voluntary exit. The White Paper on the Reform of Australia's Tax System should consider simplifying and streamlining the small business CGT concessions with a view to the effectiveness of implementation, avoidance of unintended consequences and ensuring consistency with broader tax policy.
- In the context of the ageing of business owners there is a need to understand what role governments should play to assist businesses in planning for exit.
  - Business exit is largely a commercial matter. Governments should provide general guidelines on exit requirements and information on commercial matters only when there is a market failure in private provision and government provision would be effective.
- Overall, inquiry participants raised very few issues associated with the efficiency and effectiveness of voluntary business exits. With the exception of CGT concession complexities, there are currently no major issues that governments need to address.

The outflow of business from the Australian economy — business exits — comprise changes in ownership (temporary exits) and cessations (permanent exits).

- Changes in ownership include businesses that are sold, taken over or merged. It includes 'successful' exits (selling out for high profits and mergers) but also businesses that are sold because of poor market performance, financial difficulties or other reasons. Changes in ownership are classified as exits because they often involve substantial changes to the operations of the business and invariably invoke transactions and other reorganisation costs.
- Cessations represent real 'deaths' where businesses cease operations altogether. The majority of cessations involve solvent businesses closing for non–financial, 'lifestyle' reasons — for example, when the owner retires or seeks a different lifestyle. However, a small proportion of cessations involve business related bankruptcy or insolvency and these are discussed in chapters 13 to 15.

The efficiency of voluntary exit is an important policy consideration. In particular, unnecessary regulatory burden and barriers to voluntary exit may hinder the efficient operation of markets by delaying the use of business assets for alternative activities such as retirement or a new business venture.

12.1 How and why do businesses exit?

The decision for a business to voluntarily exit does not always relate to financial performance. Some commonly cited reasons for voluntary business exit include:

- retirement
- an opportunity for a merger which may ensue benefits from increased market power, diversity or taxation arrangements
- the owner wishes to seek a different lifestyle
- it is time to pass the business on to family members
- increased competition has reduced (or is expected to reduce) business profitability
- concern that falling profit may in the future lead to bankruptcy or insolvency
- the owner has new plans and wants to generate capital, sell the business and use the cash for other purposes
- changes in family circumstances, such as illness or divorce
- the owner is moving out of the area (CPA Australia nd).

Regardless of the reason for voluntary exit there are a number of different exit strategies a business can choose. The main pathways for voluntary business exit include family succession, trade sale, merger, transfer to employees, management buyout, initial public offering, private placement and cessation. These are summarised in box 12.1.

Box 12.1 **Pathways for voluntary exit**

Family succession

Family business succession involves transferring the business to the next generation of family members. Realisation of the wealth of the business to generate retirement income, continuity of the business and achieving family harmony are the key targeted outcomes of succession arrangements.

There is a range of methods that may be used to transfer a family business to the next generation including family trust arrangements, establishment of the business as a company, purchase of the business by the successors, or gifting the business to the successors. The management and choice of succession arrangements differ between businesses and is influenced by a family's personal, social and business values.

Trade sale (acquisition)

In a trade sale, the business is sold to another business such as a competitor, supplier or customer that views strategic and cost advantages in acquiring the business. The acquirer may or may not retain the current management team, and may make substantial changes to business operations and staffing. While the business owner may be able to sell most or all of the stock, valuing and selling the intangible assets (goodwill) of a business may be difficult for some owners. Goodwill includes customer loyalty and relations, brand recognition, staff performance, customers lists, reputation and operational procedures. While most businesses have an element of goodwill it is particularly important for retail and service-based businesses.

Merger

In contrast with a trade sale where the acquiring business absorbs the business into existing operations or as a subsidiary, a merger involves the owners of two businesses becoming the owners of a new merged business. Some of the most common reasons for merger are to increase market share, diversify, improve the productivity of resources, reduce risk exposure and to reduce tax and transactions costs such as marketing expenses.

Business mergers can take three forms — horizontal, vertical and conglomerate.

- Horizontal mergers occur between businesses that supply a similar or substitutable good or service. This type of merger eliminates competition between the two businesses.
- Vertical mergers involve businesses that operate in the same broad industry but at different stages of production or distribution. Backward integration occurs when a business merges with an input supplier. Conversely, forward integration is when a business merges with part of its distribution chain.
- Conglomerate mergers involve businesses in unrelated business activities. Pure conglomerate mergers involve businesses with nothing in common, while mixed conglomerate mergers involve businesses that are looking for product or market extensions or diversification.
  - A market extension merger takes place between two businesses that supply the same product or service but in separate markets. The aim of the merger is to enable the merging businesses to access a larger market.
  - A product extension merger takes place between two businesses that supply goods or services that are related to each other and operate in the same market. The merger allows the merging businesses to group their products together with the aim of increasing the number of customers or sales of both products.

(continued next page)

Box 12.1 (continued)

Transfer to Employees

A business can be transferred to employees through employee share ownership plans (ESOP). ESOPs are generally operated using a trust (chapter 4) which can help to fund the share purchase for employees (West 2013).

An ESOP allows an owner to continue to have a significant role in the business, but with the flexibility to start reducing their equity in the business by selling it to employees. It allows owners to begin to access capital for other purposes such as a new business venture or retirement.

Employee share plans are increasingly being used as an exit strategy for small business.

> The preference of implementing an employee share plan as opposed to other exit strategies (or in fact as stage one of an overall exit strategy) is gaining momentum in Australia and is equally gaining popularity amongst SMEs. The reason — great benefits are realised to the business owner, the employees and the business through improvements to retention, motivation, performance, productivity and profitability. (West nd)

Management buyout

A management buyout involves selling the business to the next generation of managers. The transaction is generally financed through a combination of debt and/or private equity investment. The benefit of a management buyout is the potential for a seamless transition for the company, employees and customers because the management team remain with the company.

Initial public offering

An Initial Public Offering (IPO) involves listing the company on a public share market. IPOs are generally used to increase equity rather than as an exit strategy as the business founders usually retain equity in the company post listing. However, it can allow a business owner to reduce their shareholding and increase the capitalisation of the business (West 2013).

This option is limited to growth businesses with high performance goals. While an IPO can provide benefits such as a large and diversified equity base IPOs are viewed as expensive (relative to other exit strategies), time consuming and the most complex business exit strategy (chapter 6).

Private placement

In contrast to an IPO where shares are sold publically, a private placement involves registering the business as a proprietary company and selling shares to chosen investors. In Australia a proprietary company is limited to no more than 50 shareholders (chapter 4).

Cessation and liquidation

Cessation and liquidation involves winding up the business by realising assets, paying outstanding debts and distributing any surplus to the business owners. Benefits are that it is a simple process, without negotiation or concern about transfer of control. However, cessation may produce very little financial reward for the owners as unmarketable assets need to be written off and the value of any goodwill in the business is lost. Cessation often occurs when the business is generating little income and is not viewed as an attractive investment for buyers or is operating in a small market with no potential buyers (such as in rural and remote areas).

The exit pathway chosen for each business is dependent on a number of factors including the ownership and management structure (chapter 4), value of a business and its potential for growth. The exit pathway has implications for future business activity — it may involve a cessation of business operations, a substantial change in the ownership, management and operation of the business or a change in ownership but with no substantial change in operations or management.

12.2 How many businesses exit without failing?

The majority of all business exits are voluntary and do not involve business failure. Hosted Accommodation Australia (HAA) — in reference to the accommodation services sector — commented:

> In the experience of HAA, except where owners have invested heavily in the development of a purpose built accommodation business, closure is rarely because of business failure. In the case of very small, owner operated establishments when there is a downturn in the economy, and where there are no liabilities on the business for the employment of staff, etc., owners choose to ride out the downturn. Alternatively, if they have been in business for a long time, they may decide that this would be a good time to close the business and retire. (sub. 22, p. 3)

The richest data sets on how businesses exit relate to those resulting from bankruptcy or liquidation (chapters 13 to 15). These reveal that approximately 6 per cent of business exits are a result of formal insolvency (chapter 2).

Unfortunately, comprehensive data are unavailable for the different forms of voluntary exit by business sub–group. Family business surveys offer some information on the exit options being considered by family businesses. However, results are mixed.

- The PWC 2014 Family Business Survey reported that 38 per cent of family businesses surveyed in Australia were planning to sell or float their business while 24 per cent intended to pass the business on to the next generation. However, this was a reversal of the 2012 results which found that more Australian businesses intended to pass their business to the next generation than sell. This reversal may reflect a more favourable market for sellers and that more family businesses have been struggling to involve the next generation in the family business (PwC 2014a).
- The KPMG and Family Business Australia 2013 Family Business Survey asked respondents which exit options they were considering and the timeframe of their likely exit. The results indicated that the majority of family businesses are considering more than one exit option with the most likely option (over 65 per cent) being passing management and ownership of the business to the next generation (table 12.1).

Table 12.13 **Exit pathways and timeframe of exit for family businesses**
Family Business Survey 2013

Exit strategy	Firms considering strategy	*Exit timeframe* Short term < 12 months	Medium term 1 to 3 years	Long term 5 + years
	per cent	per cent	per cent	per cent
Passing senior management to next generation	67	18	25	57
Passing ownership to next generation	66	9	20	71
Sale to a competitor/trade sale	47	11	24	65
Sale to an independent third party	46	10	25	64
Appointment of non-family CEO or MD but ownership and control remains within family	42	14	24	62
Sale to a private equity consortium	23	14	20	66
Sale to current employees	21	11	14	75
Closure	18	11	13	76
Sale to family member	17	10	9	81
Initial public offering	16	3	14	83

Source: KPMG and Family Business Australia (2013)

Further, the PWC 2014 survey reported that of the 38 per cent of businesses considering sale:

- 68 per cent were considering selling to another company
- 32 per cent were considering a sale to private equity investors
- 26 per cent were considering selling to the management team
- 8 per cent were considering and initial public offering (PwC 2014a).

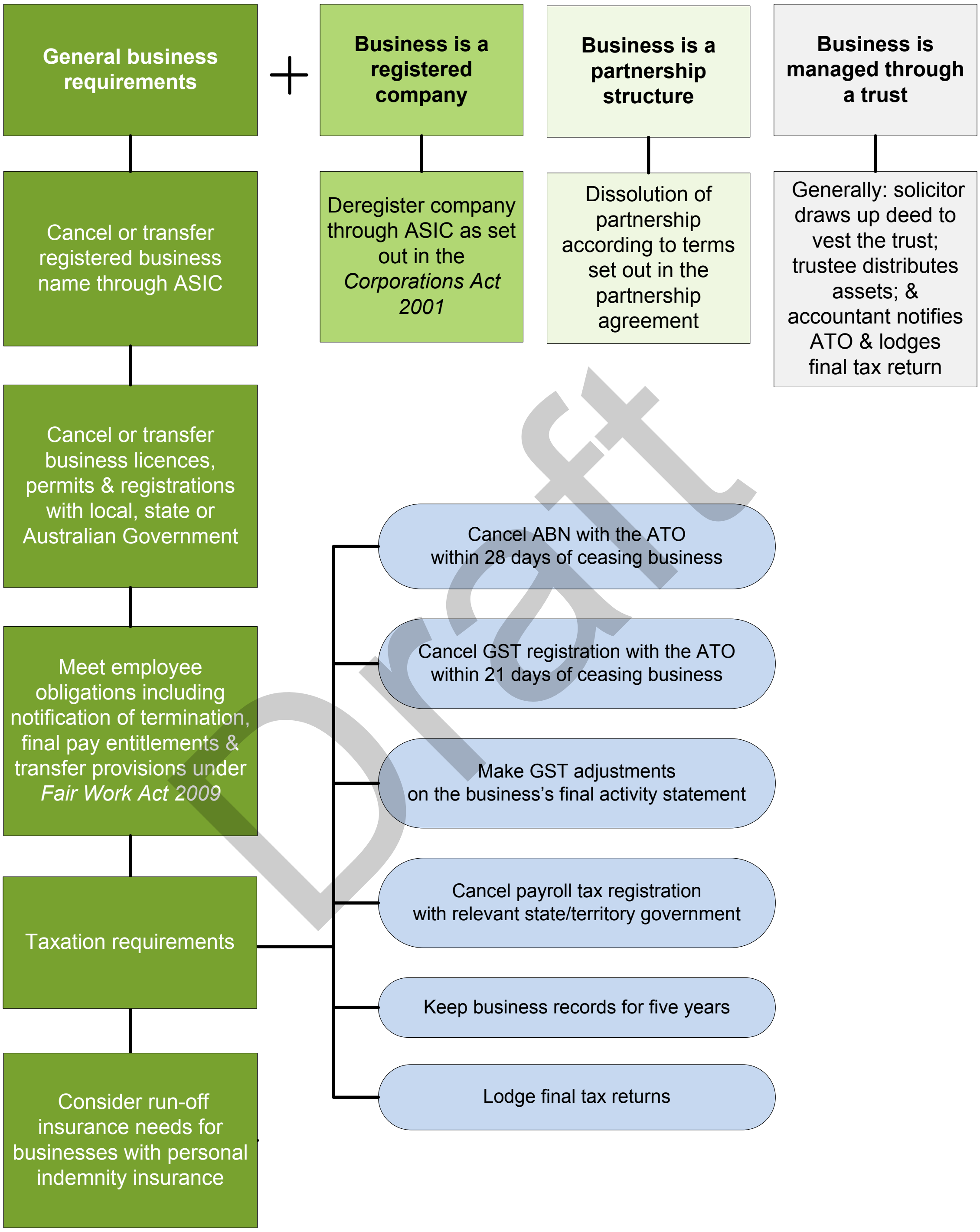
Although many business owners choose sale as the preferred business exit option, for the majority, this is not realised. The Commission was informed that it is widely acknowledged within the business community that around 40 per cent of businesses listed by a business broker will be sold and the remainder are closed.

12.3 Business exit requirements

There are a number of general requirements that must be completed when a business is closed or transferred to a new owner. These are outlined in figure 12.1.

Stakeholders noted the complexity and time it takes a business to exit is directly related to the size, structure and the specific circumstances of the business. A sole trader operating from home may only take a couple of weeks to close down, but larger companies with complex operations may take several years to deregister (Queensland Government 2015c). Box 12.2 summarises the procedures required to deregister a company.

Figure 12.1 **Business exit requirements**



Box 12.2 Winding up a solvent company

Generally, there are two ways to deregister a solvent company — voluntary deregistration or a members' (shareholders') voluntary winding-up.

Voluntary deregistration

An application can be made to ASIC to voluntarily deregister a company. If a company meets the following legal requirements:

- all members of the company agree to deregister
- the company is not carrying on business
- the company's assets are worth less than $1000
- the company has no outstanding liabilities, including unpaid employee entitlements.
- the company is not a party to any legal proceedings
- the company has paid all fees and penalties payable under the *Corporations Act 2001* (Cth).

Members' (shareholders') voluntary winding-up

To commence a members' voluntary winding-up, the majority of company directors must make a solvency declaration that the company will be able to pay its debts in full within 12 months from the commencement of the winding-up. If a director makes this declaration and it is later discovered that he or she did not have reasonable grounds for making the declaration, then they may face a penalty of up to $8500 and one year in jail under the Corporations Act.

A liquidator is appointed by members of the company to manage the day-to-day running of the company and the liquidation process. In the case of a company limited by guarantee, the person appointed must be a registered liquidator and in most cases will be an accountant who specialises in liquidation work.

The next step involves the company passing a special resolution that the company be wound up voluntarily. All members (as defined under section 231 of the Corporations Act) must be given at least 21 days' notice of the special resolution meeting and at least 75 per cent of the votes cast by members must be in favour of the resolution for it to be passed. Notice of the resolution must be then published on the ASIC insolvency notices website within 21 days after the resolution is passed.

The liquidator completes the winding-up process by selling company assets, paying outstanding debts and distributing surplus funds as set out in the company's constitution. A number of forms must be lodged during a members' voluntary winding-up process.

- A declaration of solvency must be lodged prior to the special resolution meeting for the winding-up of the company. The resolution must be passed within 5 weeks after the date of making the declaration of solvency.
- Notification of resolution must be lodged within 7 days after passing the resolution.
- Notification of appointment or cessation of an external administrator must be lodged within 14 days after appointment.
- Presentation of accounts and statements must be lodged within one month after the first six month period (and every six months) from the date of the liquidator's appointment.
- Notification of final meeting must be lodged with an account of how the winding-up was conducted, within 7 days after the final meeting. The meeting must be advertised on the ASIC insolvency notices website at least one month before it is to be held.

The company is deregistered three months after the final form is lodged.

Source: ASIC (2015a)

Small business stakeholders commented that some small businesses may struggle with the cumulative burden of requirements when exiting from business and dealing with three levels of government. The Australian Small Business Commissioner commented:

> Selling or closing a business can be a very complex process and many small business operators lack the understanding, skills, time and resources to navigate this process. This, of course, includes fulfilling the requirements of the three levels of government. (sub. 10, p. 4)

Section 12.4 discusses the role of governments in providing guidance on business exit.

Transfer of employee conditions and entitlements

Dealing with requirements for the transfer of business provisions under the *Fair Work Act 2009* (Cth) were noted by a number of stakeholders as overly complex and time consuming (box 12.3). For example, Master Electricians Australia commented:

> The complexity surrounding workplace laws is problematic for business owners at the best of times. However, when transferring ownership of a business this complexity is intensified. The broad scope of the 'transfer of business' rules of the Fair Work Act are common areas that have created obstacles for business owners seeking to transfer their business. (sub. 6, p. 2)

Box 12.3 Transfer of business provisions under the Fair Work Act

The intention of Transfer of business provisions under the *Fair Work Act 2009* (Cth) is to enable employees to retain their existing conditions and entitlements when a business is transferred.

Under the Fair Work Act there is a transfer of business if:

- an individual's employment is terminated by one business (the old employer) and then started with another business (the new employer) within a period of three months;
- the individual performs the same, or substantially the same, work for the new employer as for the old employer; and
- there is a connection between the old employer and the new employer (for example, the new employer purchases assets from the old employer and then uses those assets in connection with the work).

Where there is a transfer of business, the Fair Work Act provides for the application of certain industrial instruments, for example enterprise agreements, to employees who move from the old employer to the new employer. The Fair Work Act also contains provisions that deal with recognition of an employee's service where there has been a transfer of employment, including in relation to unfair dismissal and redundancy pay.

Source: Department of Employment (sub. 12)

Ai Group listed a number of issues associated with the current transfer of business laws and in particular that the Fair Work Act is:

- impeding the restructuring of Australian businesses and hence impeding productivity and competitiveness
- increasing redundancies and removing employment opportunities for many Australian workers
- discouraging organisations which win outsourcing contracts from employing any of their clients' workers and, hence, many of these workers are made redundant by the client
- constraining opportunities for companies in the business of outsourcing (e.g. Information, Communication and Technology ('ICT') companies)
- deterring companies that wish to outsource functions from doing so and consequently opportunities for productivity improvement are lost. (sub. 27, pp. 22-23)

The performance of the Workplace Relations Framework including the Fair Work Act is the focus of a separate inquiry currently being undertaken by the Productivity Commission.

The tax treatment of losses under the same business test

Chapter 4 discussed how the tax treatment of losses can affect expansion and investment in new enterprises. Businesses also need to take into account transfer of losses when planning to exit.

Under taxation law, the continuity of ownership test (COT) disallows the use of carry forward losses when a company undergoes a substantial change in underlying ownership. However, the same business test (SBT) can be applied when a business does not satisfy the COT. The SBT is intended to prevent the COT from acting as a barrier to changes in business ownership.

A business satisfies the SBT if:

- it carries on the same business in the claim year as it carried on immediately before it failed the COT
- it does not derive assessable income from a type of business it did not carry on before the test time (new business test)
- it does not derive assessable income from a kind of transaction it had not previously entered into before the test time (new transaction test). (ATO 2013a)

In 2012, the Business Tax Working Group recommended a review of loss integrity rules (particularly the same business test) to ensure the right balance between supporting appropriate risk taking and innovation, and maintaining appropriate integrity (Business Tax Working Group 2012). This was raised in the recent White Paper on the Reform of Australia's Tax System discussion paper (The Treasury 2015b) and should be considered further as part of the white paper process.

The regulation of mergers and acquisitions

Mergers and acquisitions are important for the efficient functioning of the economy. They allow businesses to achieve efficiencies such as economies of scale or scope and diversify risk across a range of activities. They also provide a mechanism to replace the managers of underperforming firms. In many cases consumers or suppliers benefit from mergers. However, the policy problem posed by mergers and acquisitions is that some may give rise to a concentration of market power so that, despite any gains in productive efficiency, society is worse off because of reduced competition that may lead to excessive prices and reduced quality.

The impact of proposed and completed mergers and acquisitions on competition is assessed by the Australian Competition and Consumer Commission (ACCC) under section 50 of the *Competition and Consumer Act 2010* (Cth). Section 50(3) requires the following non-exhaustive list of matters to be taken into account when assessing whether an acquisition would be likely to substantially lessen competition:

- the actual and potential level of import competition in the market
- the extent of barriers to entry to the market
- the level of concentration in the market
- the degree of countervailing power in the market
- the likelihood that the acquisition would result in the acquirer being able to significantly and sustainably increase prices or profit margins
- the extent to which substitutes are available or are likely to be available in the market
- the dynamic characteristics of the market, including growth, innovation and product differentiation
- the likelihood that the acquisition would result in the removal from the market of a vigorous and effective competitor
- the nature and extent of vertical integration in the market.

The application of section 50 to mergers and acquisitions is discussed in detail in the ACCC Merger Guidelines (box 12.4).

Box 12.4 The ACCC approach to merger reviews

Section 50 of the *Competition and Consumer Act 2010* (Cth) applies to a wide range of mergers and acquisitions. As there are no differences, in the assessment processes, between mergers and acquisitions the ACCC *Merger Guidelines* use the terms 'mergers' and 'merger parties' when referring to both mergers and acquisitions under section 50.

Merger parties have three avenues available to have a merger considered and assessed under section 50 of the Competition and Consumer Act.

- An ACCC informal clearance process enables merger parties to seek the ACCC's view on whether it will seek an injunction under section 50 to stop a merger from proceeding. The process provides flexibility in terms of timeframes, information requirements and confidentiality.
- An ACCC formal merger clearance seeks legal protection from court action under section 50. The process has mandated timeframes and information and transparency requirements.
- An Australian Competition Tribunal merger authorisation grants legal protection under section 50 if the Tribunal is satisfied that the proposed merger provides public benefits that outweigh the merger's detriment to competition.

As there is no legislative requirement that parties notify the ACCC of a proposed acquisition, merger parties also have the option of proceeding with a merger without seeking any regulatory consideration. However, proceeding without regulatory approval may put merger parties at risk of the ACCC or other interested parties taking legal action on the basis that the merger would or be likely to substantially lessen competition in the relevant market.

To assist merger parties determine whether the ACCC should be notified, the ACCC has developed a notification threshold which states that:

> Merger parties are encouraged to notify the ACCC well in advance of completing a merger where both of the following apply:
>
> - the products of the merger per parties are either substitutes or complements
> - the merged firm will have a post-merger market share of greater than 20 per cent in the relevant market/s. (ACCC 2008, p. 9)

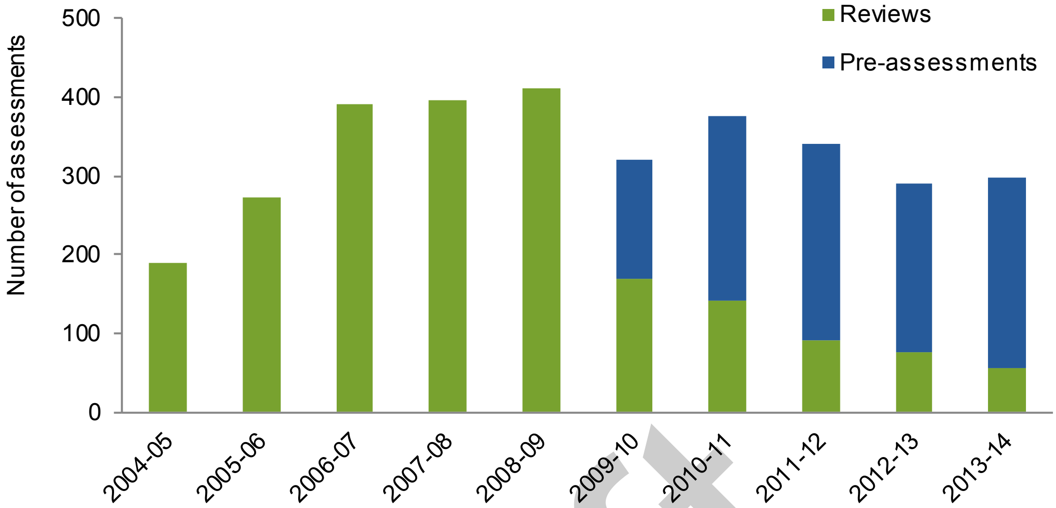
If the ACCC forms the view that a merger proposal is likely to contravene section 50, the merger parties may: not proceed with the merger; provide a court enforceable undertaking to address ACCC concerns (such as change the structure of the merged firm through divestiture of part or all of a business); or proceed and defend court action under section 50.

Source: ACCC (2008)

How many businesses are assessed for merger or acquisition?

Each type of merger and acquisition has the potential to affect competition in a different way. The ACCC therefore assesses each merger and acquisition on its merits according to the specific nature of the transaction, the industry and the particular competitive impact likely to result in each case. The number of mergers and acquisitions assessed by the ACCC has varied considerably over the last decade (figure 12.2). Of the mergers and acquisitions reviewed each year, the majority are not opposed by the ACCC (table 12.2).

Figure 12.2 **ACCC assessments of mergers and acquisitions[a]**



[a] Matters which were cleared through a preliminary assessment and those which were subject to a review were not distinguished prior to 2009-10.

Source: Information provided by the ACCC

Table 12.2 **Outcomes of ACCC assessments of mergers and acquisitions**

	Publicly opposed[a]	*Confidential concern[b]*	*87B[c] undertaking*	*Not[d] opposed*	*Pre-assessed[e]*	*Withdrawn[f], no decision*	*87B[g] variation*	*Total*
2004-05	2		9	178				189
2005-06	0	3	8	235		26		272
2006-07	6	11	8	335		25	5	390
2007-08	5	6	6	353		23	4	397
2008-09	1	9	5	371		26		412
2009-10	8	6	4	131	153	16	3	321
2010-11	3	4	7	110	236	14	3	377
2011-12	1	6	3	60	250	17	3	340
2012-13	6	5	2	55	213	4	4	289
2013-14	4	2	10	36	242	2	1	297

[a] If a public review merger or acquisition concluded that it does or may substantially lessen competition then the ACCC would publicly oppose it. [b] If a confidential review of a merger or acquisition concluded that it does or may substantially lessen competition the ACCC advises the parties of its concerns and would conduct a public review should the merger parties wish to proceed with the transaction. [c] If the ACCC is satisfied that the terms of an undertaking would remedy competition concerns the ACCC accepts the undertaking and does not oppose the transaction. [d] If the ACCC concludes that the merger or acquisition is not likely to substantially lessen competition it does not oppose the transaction. [e] Matters that were cleared through a preliminary assessment and those that were subject to a review were not distinguished prior to 2009-10. [f] Includes mergers and acquisitions that did not proceed after the ACCC commenced a review but prior to the ACCC's decision. Generally, the parties advised that they were not proceeding and withdrew their request for clearance. [g] If the ACCC has accepted an undertaking to remedy competition concerns and the party requests to vary it, the request is subject to a review.

Source: Information provided by the ACCC.

Improving merger and acquisition assessments

Business issues related to mergers and acquisitions assessments were examined in the 2015 *Competition Policy Review* (Harper Review), to which the Business Council stated:

> The Business Council has in its submission to the Competition Policy Review suggested the following areas for improving the accuracy and cost-effectiveness of decisions on mergers and acquisitions:
>
> - Amend the Competition and Consumer Act (CCA) definitions of "market" and/or "competition" to give legislative guidance to the principle that competition analysis should begin with an assessment of market dynamics – such as the extent of rivalry and barriers to entry – rather than concentration and static market definition.
> - Streamline the Australian Competition and Consumer Commission's (ACCC) formal and informal merger assessment processes.
> - Regular ex-post reviews of ACCC decisions could be used to improve future decision making by examining *process issues* (such as whether the ACCC's internal steps were conducted in a timely and efficient manner) and *substantive issues* (including whether the assumptions used in the decision making have been borne out). (sub. 29, p. 10)

The Harper Review found that overall, the merger provisions of the *Competition and Consumer Act 2010* (Cth) were working effectively and changes to the substantive law were not required but recommended a number of changes to merger approval processes (box 12.5).

In line with the Harper Review the Commission supports more streamlined merger assessment processes.

DRAFT RECOMMENDATION 12.1

In line with recommendations from the Harper Review, the Australian Competition and Consumer Commission should implement more streamlined formal merger exemption processes that remove unnecessary restrictions and requirements and improve the efficiency and effectiveness of business transfer processes.

Box 12.5 **Competition Policy Review of merger assessment processes**

The Competition Policy Review Panel recommended that:

There should be further consultation between the ACCC and business representatives with the objective of delivering more timely decisions in the informal merger review process.

The formal merger exemption processes (that is, the formal merger clearance process and the merger authorisation process) should be combined and reformed to remove unnecessary restrictions and requirements that may have deterred their use. The specific features of the review process should be settled in consultation with business, competition law practitioners and the ACCC.

However, the general framework should contain the following elements:

- The ACCC should be the decision-maker at first instance.
- The ACCC should be empowered to authorise a merger if it is satisfied that the merger does not substantially lessen competition or that the merger would result, or would be likely to result, in a benefit to the public that would outweigh any detriment.
- The formal process should not be subject to any prescriptive information requirements, but the ACCC should be empowered to require the production of business and market information.
- The formal process should be subject to strict timelines that cannot be extended except with the consent of the merger parties.
- Decisions of the ACCC should be subject to review by the Australian Competition Tribunal under a process that is also governed by strict timelines.
- The review by the Australian Competition Tribunal should be based upon the material that was before the ACCC, but the Tribunal should have the discretion to allow a party to adduce further evidence, or to call and question a witness, if the Tribunal is satisfied that there is sufficient reason.

Merger review processes and analysis would also be improved by implementing a program of post-merger evaluations, looking back on a number of past merger decisions to determine whether the ACCC's processes were effective and its assessments borne out by events. This function could be performed by the Australian Council for Competition Policy.

Source: Harper et al. (2015, p. 67).

12.4 Issues in voluntary exit

Inquiry participants raised two key areas of concern in relation to voluntary business exit:

- the burden of capital gains tax and the complexity of small business capital gains tax concessions
- the challenge for business in transitioning through demographic change and whether businesses have adequately planned for exit.

Capital gains tax considerations

One of the most complex, time consuming and costly issues for business owners to address when a business is sold or transferred, is their tax liability. In particular, capital gains tax (CGT) considerations have been raised as a key concern for businesses, and in particular, for small and family businesses.

> A big problem for family businesses is that passing the firm onto the next generation usually triggers capital gains tax. In many cases the need to pay a big CGT bill means a family simply can't afford to retain the business and pass it onto the next generation — they have to sell it and the kids have to start another business of their own, taking big risks, or get a job. (Kohler 2015)

The four small business tax capital gains tax concessions

In Australia, CGT has been payable on the sale of equity in a business since 1985 (businesses which commenced operation prior to 1985 are CGT exempt). CGT concessions targeted at small business have been a feature of the CGT regime since its introduction. The rationale behind the concessions is to provide small business greater access to additional funds to grow their business or to provide for retirement.

Originally, small businesses had access to a 20 per cent goodwill exemption but that rate was later increased to 50 per cent. Over time, the CGT concessions have been progressively expanded in recognition of the particular circumstances (including the riskiness of investment) that often face the owners of small businesses (ATO 2014).

Currently, there are four small business CGT concessions:

- the 15 year exemption — capital gains tax is not payable on the sale of business assets if they are owned for more than 15 years and the owner is aged over 55 years and is retiring or permanently incapacitated
- the small business retirement exemption — capital gains tax is not payable if the owner is under 55 years old and amounts are paid into a superannuation fund or retirement savings account (subject to $500,000 lifetime limit)
- the 50 per cent active asset reduction — sale of assets attracts a 50 per cent capital gains tax discount
- the small business roll-over — capital gains tax is deferred if the funds are used to replace small business assets or make a capital improvement to an existing asset (The Treasury 2015b).

A small business owner is able to access the small business CGT concessions by either satisfying the *turnover test* or the *net asset value test*.

- A small business satisfies the turnover test if it has less than $2 million aggregated turnover. Aggregated turnover is annual turnover plus the annual turnovers of any connected entities or affiliates. Generally, this is tested in the year prior to the year of the capital gain but, where this test cannot be satisfied, an entity may be eligible to use the estimated or actual turnover for the current year.
- A small business satisfies the maximum net asset value test if the net value of CGT assets owned by the entity, its connected entities and affiliates, worked out just before the realisation, is no more than $6 million.

The four small business CGT concessions are the most significant tax concessions available to small business. In 2013-14 the concessions were valued at $1.4 billion which includes: $600 million for the 50 per cent active asset reduction; $390 million for the small business retirement exemption; $220 million for small business roll-over relief for replacement small business entity active assets; and $160 million for the 15 year exemption (The Treasury 2015b).

Stakeholder views

Generally, the small business CGT concessions are viewed by stakeholders as generous. For example, the IPA *Australian Small Business White Paper Summit* reported:

> A number of existing concessions such as the 50 per cent reduction and the 15 year exemption are highly concessional, and can eliminate any CGT liability when business owners exit their investment. These concessions are generally uncapped and are generous tax concessions. (IPA 2014, p. 9)

However, inquiry participants raised a number of issues associated with the small business CGT concessions including:

- complexity surrounding criteria eligibility
- differences in the tax treatment of capital gains between different business structures
- the CGT burden on families transferring business ownership.

Box 12.6 presents the key concerns raised by inquiry participants and table 12.3 presents a table (submitted by CPA Australia) that highlights the different treatment of CGT concessions across different business structures.

Box 12.6 Inquiry participants' comments about capital gains tax concessions

The Institute of Public Accountants:

> The small business CGT concessions are overly complex. Whilst the rules were subject to a post-implementation review by the Board of Tax, the eligibility rules need to be simplified. Their complexity in part is due to having to deal with multiple business structures and anti-avoidance provisions. There is an opportunity to rationalise and streamline the CGT concessions which has also been recommended by the Henry Review. The four current and separate small business CGT concessions require taxpayers to navigate complex legislation. These concessions impede the efficient transfer or closure of small businesses. (sub. 32, p. 40)

CPA Australia:

> In our view the most disputed and litigated aspect of the small business CGT concessions is the ability of a taxpayer to satisfy the $6 million maximum net asset value test where the requirements of the $2 million aggregated turnover test are not otherwise met in satisfying the basic eligibility conditions in claiming the concessions.
>
> This is partly due to the complex eligibility criteria to meet the maximum net asset value test as set out under sections 152-15 and 152-20 of the Income Tax Assessment Act 1997 (the ITAA 1997).
>
> In practice, many small business taxpayers whose eligibility is contingent on meeting the $6 million maximum net asset value test fail to include the net value of CGT assets of connected entities or affiliates, or incorrectly exclude pre CGT acquired assets or post CGT acquired assets such as depreciating assets or trading stock which do not generate capital gains but must nonetheless be included in that calculation.
>
> However, the most problematic aspect of the maximum net asset value test is the inherently subjective nature of determining the market value of the taxpayer's CGT assets which can lead to disputation between the ATO and taxpayers where they have different competing market valuations of assets.
>
> Accordingly, we believe that it may be prudent to replace the current subjective maximum net asset value test with some alternate objective test for small business taxpayers which is easier to comprehend and apply with certainty. (sub. 30, p. 12)

The Australian Trucking Association:

> The intent of business taxes is to collect revenue in the simplest way possible, and in a way that does not prevent businesses from growing, employing more people and contributing to economic growth. CGT on businesses transferred to offspring works against this. When a parent passes on their business to the second generation they receive no benefit. They are effectively passing on their source of income. It is not at all obvious why they should pay CGT out of the family's pool of assets.
>
> The heir could be liable if they choose to sell the business outside of the family as they are then benefitting financially from the sale, but a simple change of company ownership within a family should not be taxed as the original sellers have not financially benefited. (sub. 13, pp. 11-12)

Table 12.3 Access to CGT concessions by business structure

	CGT discount	Active asset reduction	Active asset retirement	Active asset rollover	Active asset 15 year exemption
Individual[a]					
Selling a business	✓	✓	✓	✓	✓
Selling a share in a company	✓	✓	✓	✓	✓
Selling an interest in a trust	✓	✓	✓	✓	✓
Trusts					
Selling a business	✓	✓	✓e	✓	✓e
Selling a share in a company	✓	✓b	✓b	✓b	✓b
Selling an interest in a trust	✓	✓b	✓b	✓b	✓b
Company					
Selling a business	×	✓d	✓e	✓	✓e
Selling a share in a company	×	✓c	✓c	✓c	✓c
Selling an interest in a trust	×	✓c	✓c	✓c	✓c
Superannuation fund[f]					
Selling a business	✓	×	×	×	×
Selling a share in a company	✓	×	×	×	×
Selling an interest in a trust	✓	×	×	×	×

a Partnership CGT assets are treated the same as if the individual held the assets themselves. **b** In order for a trust to access the small business CGT concessions there must be a beneficiary of the trust that is a significant individual in the company or trust in which the investment is held and that significant individual and other CGT concession stakeholders must have a combined participation percentage of at least 90 per cent. **c** In order for a company to access the small business CGT concessions there must be a shareholder of the company that is a significant individual in the company or trust in which the investment is held and that significant individual and other CGT concession stakeholders must have a combined participation percentage of at least 90 per cent. **d** To receive this concession the capital gain must be paid out on liquidation of the company. **e** In order for the portion of the CGT sheltered by the retirement exemption from a company or trust to be exempt, funds must be paid to the significant individual or their spouse that also holds an interest in the company or the trust. **f** A superannuation fund cannot claim the CGT small business concession as it does not carry on a business.

Source: CPA Australia (sub. 30, p. 19).

Reviews of small business taxation

Issues raised by participants to this inquiry are not new and have been raised in a number of reviews. Concerns about the complexity of small business CGT concessions were raised in the 2010 Henry review on Australia's Future Tax System. The review recommended rationalising and streamlining the current small business CGT tax concessions:

> The capital gains tax regime should be simplified by rationalising and streamlining the current small business capital gains tax concessions by:

- removing the active asset 50 per cent reduction and 15-year exemption concessions
- increasing the lifetime limit of the retirement exemption by permanently aligning it with the capital gains tax cap for contributions to a superannuation fund
- allowing taxpayers who sell a share in a company or an interest in a trust to access the concessions via the turnover test. (Henry et al. 2010)

Box 12.7 outlines the rationale behind these recommendations.

Box 12.7 Henry tax review: rationalising and streamlining small business capital gains tax concessions

The 2010 Henry review on Australia's Future Tax System reported that:

- Rationalising the small business capital gains tax concessions by removing the active asset 50 per cent reduction and the 15 year exemption and streamlining the remaining concessions would reduce compliance costs as well as improve efficiency and equity around the treatment of earned income.
- The small business roll-over provision would be retained, as it has an efficiency benefit of reducing lock-in effects that prevent assets and businesses being reallocated and organised most productively.
- Two of the existing concessions — the 15 year exemption and the retirement exemption — raise issues related to the self-employed and superannuation arrangements, and the principle that lifetime savings should face little or no income tax. Many self-employed people effectively use the accumulation of value in their business as a lifetime savings vehicle for their retirement. But the system should be simplified by providing the retirement exemption only.
- Access to the retirement exemption should be increased and better aligned to concessions available within the superannuation system. The current lifetime contribution limit should be increased and permanently aligned to the cap for contributions to a superannuation fund derived from the disposal of small business assets. This would increase the current lifetime limit from $500,000 to $1.1 million (in 2009–10), and ensure the limit is indexed annually.
- The small business CGT concessions could also be rationalised and simplified by allowing taxpayers who sell a share in a company or an interest in a trust that is a small business entity to access the concessions using the turnover test. Under the current arrangements the concessions can only be accessed under the maximum net asset value test. Under the recommendation, owners of businesses who already access the other small business concessions will not need to determine eligibility under the maximum net asset value test, and instead rely on the same test used to access the other small business concessions.

Source: Henry (2010).

More recently, CGT arrangements for small business were raised in the Board of Taxation's 2015 review of tax impediments facing small business. The Board observed that:

> CGT is an issue of particular importance for small businesses. Small businesses are often exposed to greater risk than larger businesses, and there is an argument that, to compensate for this risk-taking, successful small business people should be allowed to keep a larger proportion of the gains from selling a successful business. In particular, the rules governing eligibility for the small business CGT concessions are exceedingly complex and difficult for small businesses to navigate. (Board of Taxation 2014, pp. 67–68)

The review discussed a number of business concerns including:

- eligibility threshold boundary tensions and whether the current thresholds should be increased
- that market valuations may be an imperfect measure in determining whether a small business entity satisfies the net asset value test
- grouping rules for calculating an entity's aggregated turnover
- deferral of CGT (in the form of roll-over relief) whenever there is a change in the legal structure of a small business but no change in the underlying ownership of its assets.

The Board of Taxation recommended that the small business entity turnover threshold be increased to at least $3 million and that the feasibility of an increase to $5 million should be investigated The Board of Taxation noted that such an increase would provide a significant number of small businesses with more certain access to a range of important concessions, including the CGT small business concessions (Board of Taxation 2014).

However, the Board of Taxation also acknowledged that raising thresholds is an incremental reform only and will not address the structural issues with the small business CGT system. It also commented that submissions to the review highlighted the importance of CGT to small businesses and that there was merit in further Government consideration.

> In particular, the Board suggests further consideration of reforms to the CGT small business concessions to better target the concessions and to eliminate the disincentives and unfairness associated with the current rules. (Board of Taxation 2014, p. 68)

Small business CGT concessions are currently being considered in the White Paper on the Reform of Australia's Tax System. The discussion paper for the review commented that 'there may be scope to simplify and streamline the small business capital gains tax concessions while ensuring that they satisfy the stated objectives'. (The Treasury 2015b, p. 116)

In light of recent reviews and participants concerns raised in this inquiry the Commission considers that there is considerable scope for improving the efficiency and effectiveness of small business CGT concessions.

DRAFT RECOMMENDATION 12.2

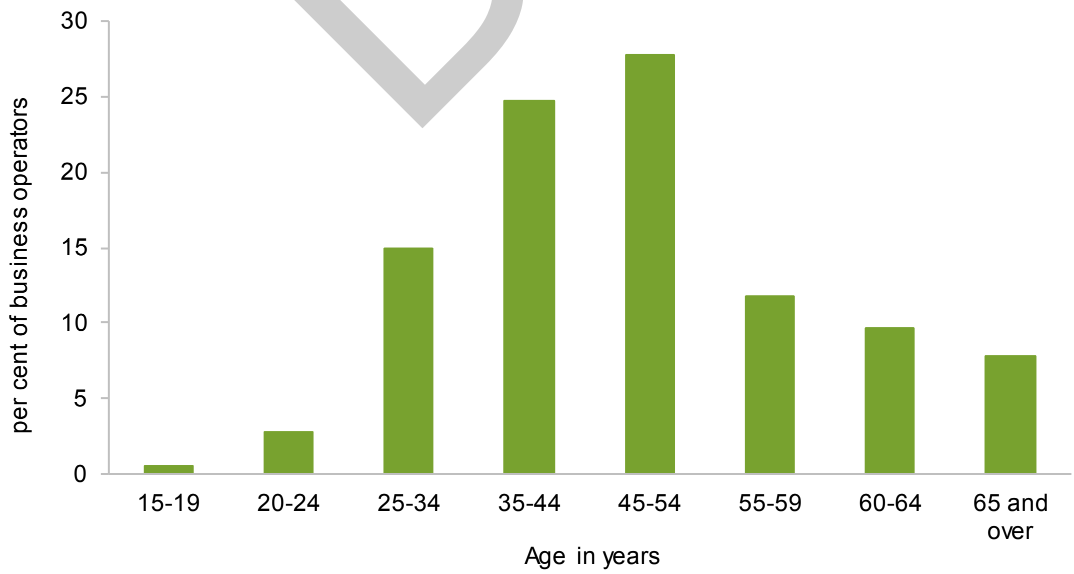
The current small business capital gains tax concessions should be rationalised. The White Paper on the Reform of Australia's Tax System should consider the recommendations of the Henry Tax Review relating to small business capital gains tax relief with a view to the effectiveness of implementation, avoidance of unintended consequences and ensuring consistency with broader tax policy.

The ageing of business owners

The ageing of business owners over the next decade is expected to coincide with an increase in the number of owners seeking to retire and exit their business, thereby bringing to a head the challenge of passing on businesses to the next set of owners.

The ABS *Counts of Business Operators Survey* found that in 2012 the greatest percentage of business operators were aged in the 45–54 years age group (28 per cent) and the majority (57 per cent) were aged over 45 years (figure 12.3). Similarly, the 2013 KPMG and Family Business Australia survey found that two thirds of family business CEOs are aged 50 years or older and nearly 20 per cent are aged 65 years or older (KPMG and Family Business Australia 2013).

Figure 12.3 **Business operators by age**
2012



Source: ABS (2013b)

Stakeholders have expressed concern that an oversupply of businesses attempting to exit (fuelled by retiring business owners) is likely to have a number of economic consequences, including retiring owners being unable to extract value from their business to fund retirement, and businesses that cannot be sold or transferred being forced to close. Compounding this problem is that many businesses are not adequately planning for voluntary exit. For example, PwC stated:

> A lack of exit planning by Australia's growing and ageing population of private business owners could have serious consequences on the owner's wealth; the business's productivity; employment and even survival; and cause a ripple effect throughout the economy. (PwC 2015)

Planning for voluntary exit

The importance of exit planning has received increasing attention in the context of ageing business owners. While each business has its own specific circumstances and priorities, in general, an exit plan identifies the exit pathways to be considered, potential buyers or successors, the timing of exit and the processes involved in selling or transferring the business. The plan should be flexible enough to change as the individual circumstances of the business change.

A common concern expressed by stakeholders was that many small and medium businesses are inactive in planning for exit.

> Most people go into business not only to earn an annual income but, more importantly to ultimately extract the wealth created with a lump sum to fund their retirement or next venture. But many don't think about how to exit their business until it is time to retire. Worse, many find they are forced to sell or leave their business suddenly due to illness, disability, debt, bankruptcy, legal disputes or divorce. (West 2013, p. 5)

The family business sector (discussed in the following section) was noted by a number of stakeholders as a particular sector where under-planning for exit may be problematic.

Family business succession

For the majority of family businesses exit planning is about preparing the next generation of the family for succession. The 2013 KPMG and Family Business Australia survey found that two thirds of family businesses intended to keep the business in family hands by passing management and ownership onto the next generation in the next five plus years (KPMG and Family Business Australia 2013).

Planning for family business succession is about ensuring the ongoing success of a business through a strategically timed transfer of ownership and control. In addition to financial and legal considerations, planning for succession for family businesses has an emotional aspect and the personal aims of family members need to be taken into account. The Australian Small Business Commissioner commented:

> It is important to understand the place of family enterprise in the business environment, and the particular issues that family business encounter… Family businesses have additional layers of complexities that add to how a business operates and its continuing success for future generations.
>
> Succession planning and the encouragement and development of the next generation are seen as long-term investments for family businesses. It is essential that succession planning is established and in place to be executed quickly, as circumstances can change overnight which will affect the family business and its operation. (sub. 10, p. 9)

Ideally, every business should have a succession plan in place as part of its overall business plan and it should be reviewed regularly and as circumstances change.

> It is evident that family businesses need to put succession plans in place early, when establishing a business. This allows for a longer and more considered implementation, rather than decisions being made that might not be the best for the longevity and success of the business. The average time that it takes to transition the business from one generation to the next takes seven years. By not having a succession plan in place, a lifetime of hard work and commitment to developing and growing a successful business is easily lost if the owner has failed to plan for succession on their retirement or exit from the business. (Australian Small Business Commissioner, sub. 10, p. 11)

However, recent surveys indicate that the majority of family businesses do not have succession plans in place. The PWC 2014 Family Business Survey reported:

> Succession planning continues to elude family businesses with only 8 per cent of Australian respondents saying they have a robust succession plan in place; compared to the global average of 16 per cent. (PwC 2014b, p. 1)

And the 2013 KPMG and Family Business Australia survey of family businesses found that only around one third of family businesses considered themselves exit or succession ready (KPMG and Family Business Australia 2013).

There are many factors that may explain why family businesses are not adequately prepared for succession (box 12.8).

However, for many family businesses, a lack of succession planning is linked to difficulties in adapting to generational change — the next generation may not be prepared, qualified or willing to manage the family business.

> In the past, succession was often seen, in one sense, as being very informal with no real planning required. Succession of the family business was just something that was expected to occur.
>
> Today the circumstances and expectations are quite different and this has created an uncertainty that is challenging many families in business. For families that choose to be in business these challenges are amplified by the complexity of business today with globalisation, the internet and digitalisation, and the changing landscape of consumer preferences, requiring many to adapt their businesses and business models to remain competitive. (Pitcher Partners and Swinburne University of Technology 2014, pp. 7–8)

Box 12.8 Challenges in preparing for succession

The Australian Small Business Commissioner stated that an owner's reluctance to properly consider succession can be caused by many different factors:

- While many business owners are very good at running their business, they are poor planners. Often, they require professional advice and expertise to assist them to think in the long term.
- Succession in family businesses can also be an emotional issue for business owners. It is natural that these owners can be reluctant to relinquish control of their creation. Quite often, the owner has identified their sense of self-worth to the business that they fear for their future without it.
- Succession planning is not usually structured or documented.
- Family members often disagree about succession options, which can lead to a particularly difficult time for the family. This includes the strong desire for long-established family businesses to keep control of the business within the family, even though successors from within the family may not be the best for the business.
- External suppliers have built up a rapport and strong relationship with the current generation. These attributes need to be earned by the next generation, not causing irreparable damage to the business relationship. (sub. 10, p. 10)

Challenges faced by family businesses in planning for succession vary according to each individual business and the life cycle stage of the business. Some general challenges include:

- identifying a successor
- determining how to generate retirement income streams while maintaining capital for the business to be viable,
- how to transfer control (wages to children, family trust, establishment of the business as a company, purchase of business by children, transfer to children)
- overcoming family conflict.

The 2013 Family Business Survey (KPMG and Family Business Australia 2013) found that balancing family concerns, maintaining family control and preparing and training a successor were the most significant challenges in succession planning (table below).

Family business issues (Family Business Survey 2013)

Issue	*Identified as important (per cent)*
Balancing family concerns and business interests	72
Maintaining family control of the business	67
Preparing and training a successor prior to succession	64
Communication between generations	63
Selecting a successor	62
Formalising the family role in the governance of the business	60
Financial literacy amongst family members	60
Informing family members of business issues	60
Compensating family members involved in the business	56
Fairness amongst family members	55

Source: KPMG and Family Business Australia (2013)

The PWC Next Generation Survey found that generally, family businesses need to address three gaps in order to successfully transition through generational change.

- The generation gap: The next generation see opportunities for change in response to global megatrends including new technologies.
- The credibility gap: Establishing the credibility and authority in the family business is one of the greatest challenges for the next generation.
- The communications gap: The differing mindset between the current and next generation can lead to 'sticky baton' syndrome where the current generation hands over the business in theory, but in reality retains control over everything that really matters. (PwC 2014c)

If generational change is not managed well (through exit planning) stakeholders are concerned that decades of business experience may be lost.

> Succession planning in Australian farming is under-developed. It may be linked to economic and social change which suggests that farmers need to adapt to generational change but this is being resisted or ignored. The implications of this are the slow decline of family farming, a poor transfer of skills and knowledge to subsequent generations of farmers in some parts of the agricultural sector. (Hicks et al. 2012, p. 94)

And that poor planning may lead to economic decline.

> This [family business] sector is experiencing a generational shift that we have not experienced before in our economies as the Baby Boomers generation exit from management and control. If this transition is not managed well, the impact on our economies will be significant. (Pitcher Partners and Swinburne University of Technology 2014, p. 3)

Managing exit planning

In the context of ageing business owners, stakeholders have expressed an increasing need to better understand what role governments and business advisors should play to ensure that businesses are able to effectively plan for voluntary exit and succession.

The Tasmanian Government commented that businesses (and in particular small businesses) require knowledge and support in order to exit successfully.

> A lack of knowledge and support can create barriers to new businesses entering the market. It can also be a barrier to recognising when and how to transfer or exit. This is particularly the case for small businesses. (sub. 18, p. 3)

Similarly, the Australian Small Business Commissioner stated:

> We believe that it is a core responsibility of government to facilitate access to or directly provide information to the small business sector. (sub. 10, p. 5)

Governments are generally more interested in supporting business entry and growth rather than voluntary business exit. However, in recognition that a lack of knowledge can create barriers to business exit, Australian governments provide general guidelines and information on what is required when closing a business and preparing for succession. Information is usually provided through online business portals and websites. For example:

- the Australian Government business portal provides a raft of information on selling and closing a business, valuing a business, dissolving partnerships and companies, changing ownership, business requirements, responsibilities in regard to employees and a succession planning template and guide (Australian Government 2015b)
- the Australian Taxation Office website provides a factsheet on tax issues to consider when planning for business exit (Australian Taxation Office 2015a)
- the Queensland Government *Business and Industry Portal* provides information on business exit including ways to exit a business, requirements in closing a business, valuing a business and succession planning (Queensland Government 2015a)
- similarly, the Government of Western Australia, Small Business Development Corporation website provides guidance material on closing or winding up a business, selling a business, selling a franchise and succession planning (Government of Western Australia, Small Business Development Corporation 2015).

While governments are best placed to provide general guidelines on exit options and processes, business exit is largely a commercial matter that each business needs to consider in its natural life-cycle. There is a range of business advisors that businesses may consult when planning for exit including accountants, financial advisors and planners, solicitors, business bankers, insurance brokers, business brokers and industry organisations. Business advisors are best placed to value a business, understand the relevant regulatory and tax requirements, prioritise needs and discuss exit options with the business owner. Their role also extends to the development of effective exit strategies and tools to help business owners transition through demographic change.

As discussed in chapter 11, governments should provide information and assistance on commercial matters only when a market failure in private provision is demonstrated.

DRAFT RECOMMENDATION 12.3

Planning for business exit is largely a commercial matter for business owners, the buyers or next generation of owners and their advisors. Governments should provide general guidelines for business and business advisors on exit requirements and provide information on commercial matters only when a market failure in private provision is clearly demonstrated and Government provision would be effective.

13 Personal insolvency

Key points

- Sole traders, individual members of a partnership, non-corporate trustees, and shareholders in companies with unlimited liability can be personally liable for debts incurred by a business. Business-related bankruptcy is responsible for approximately 21 per cent of all bankruptcy in Australia.
- There are three main personal insolvency administrations — bankruptcy, Personal Insolvency Agreements (PIAs) and debt agreements — available to individuals.
  - Personal insolvency can be initiated by either creditors (during bankruptcy) or the business (in the case of bankruptcy, PIAs or debt agreements).
  - PIAs and debt agreements are essentially forms of personal restructuring. Their use is increasing, but bankruptcy is still the dominant form of personal insolvency.
- While there are prima facie arguments for the consolidation of the regulation of personal and corporate insolvency, the Commission considers that the administrative costs involved with creating new legislation or a new regulatory body suggest that efforts should instead continue to be focused on alignment of requirements under both laws.
- Bankruptcy results in an 'exclusion period' during which the bankrupt individual cannot act as a company director, and is restricted in terms of access to finance, employment opportunities and overseas travel.
  - The Commission considers that this exclusion period should be reduced from three years to one year, but the trustee and courts should retain the power to extend the period to up to eight years. This should reduce the stigma attached to bankruptcy, and encourage entrepreneurs to start new businesses, while still preserving regulatory oversight to prevent abuse of the bankruptcy process.

Personal insolvency occurs when an individual is unable to pay their debts as and when they fall due (AFSA 2015d). Any regulation (or regulatory process) inhibiting efficient personal insolvency proceedings can slow down and increase the costs of business exit for those involved. In addition, forward looking entrepreneurs may see an inefficient or lengthy personal insolvency process as a disincentive to start a business. The personal insolvency process is designed to protect creditors, and society, from disreputable or unscrupulous businesses, while not unduly penalising genuine entrepreneurs whose ventures have been unsuccessful on entirely honest and legitimate grounds. An efficient personal insolvency process should achieve the correct balance of these incentives.

13.1 Characteristics and trends in personal insolvency

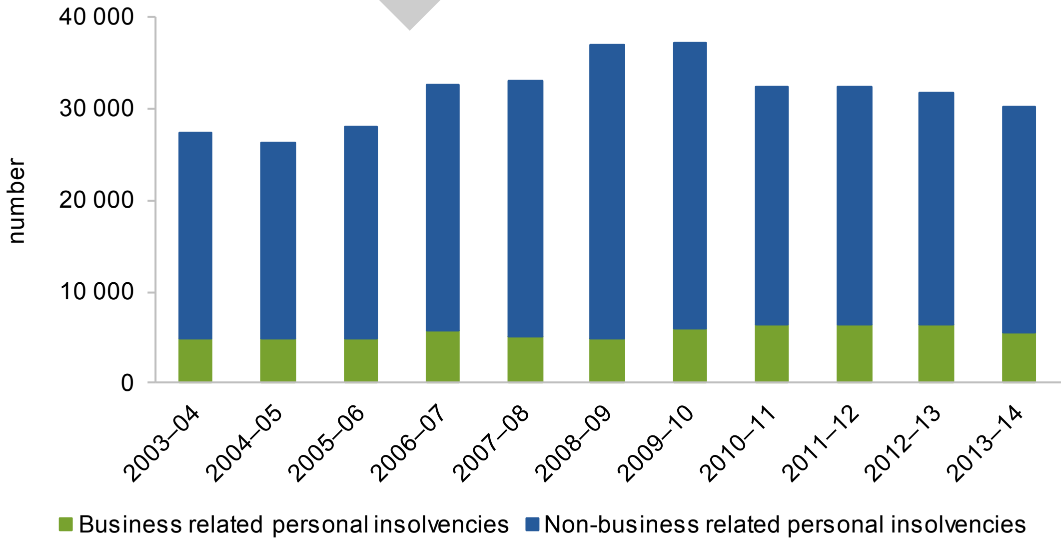
While personal insolvencies are influenced by a range of factors, and overarching economic conditions, examining the nature of personal insolvency can reveal information about its relationship with business and particular industries.

Business related and non-business related personal insolvencies

Sole traders, individual members of a partnership, non-corporate trustees, and shareholders in companies with unlimited liability can be personally liable for debts incurred by a business. As identified in chapter 4, of these, sole traders are the most common structure used in Australia under which individuals may be personally liable for debts. There were over 555 000 sole proprietors in Australia as of 2013-14, representing approximately 26 per cent of all businesses (ABS 2015c). Sole traders are often self-funded or 'bootstrapped' (see chapter 5) and individual owners will therefore be responsible for financing any debts or losses incurred by the business. As a result, when a sole trader company fails or enters insolvency, an individual may become bankrupt.

A business related personal insolvency occurs where an individual's bankruptcy, debt agreement or personal insolvency agreement is directly related to his or her proprietary interest in a business (AFSA 2015a). While non-business related bankruptcies relating to consumer unemployment, income and use of credit are the dominant sources of bankruptcy, business-related factors are responsible for approximately 20 per cent of all bankruptcy, and 16 per cent of all cases of personal insolvency in Australia (AFSA 2015b) (figure 13.1).

Figure 13.1 **Business and non-business related personal insolvencies**



Source: AFSA (2015f)

From 2003-04 to 2013-14, business related personal insolvencies occurred at a relatively consistent rate, reaching a low of around 4800 in 2005-06 and a peak of about 6400 in 2012-13. Non-business related personal insolvencies were around five times more common throughout this period than business related personal insolvencies. Business related personal insolvencies were at their highest relative to non-business related personal insolvencies in 2012-13, representing 25 per cent of total personal insolvencies for the period.

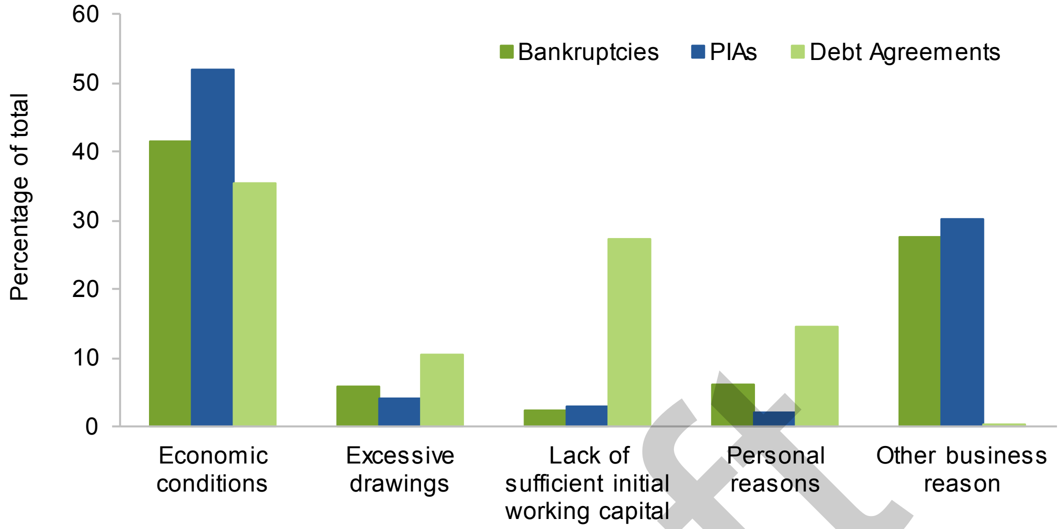
The occurrence of business related personal insolvencies varies within different sectors of the economy. Construction trades workers represented the highest number of debtors entering a business related personal insolvency in 2013-14, followed by road and rail drivers, hospitality, retail and service managers and other technicians and trades workers (figure 13.2). Business related personal insolvencies, at a sectoral level, have remained relatively stable over recent years. The most commonly reported cause of business related personal insolvency in 2013-14 for all three administrations was 'economic conditions' (figure 13.3).

Compared to other jurisdictions with similar insolvency las, Australia has the lowest number of personal insolvencies per capita (0.14 per cent), followed by New Zealand (0.16 per cent), England and Wales (0.22 per cent), Canada (0.36 per cent), and the United States (0.45 per cent) (ITSA 2012). However, the Commission notes that such figures do not capture the wider context or cause of personal insolvencies, and comparisons should therefore be undertaken with caution.

Figure 13.2 **Business related personal insolvencies by occupation**
2013-14

Source: AFSA (2014d)

Figure 13.3 **Causes of business related personal insolvencies**
2013-14



Source: AFSA (2014b)

Time and cost of personal insolvency regimes

There is a lack of data regarding the average length of personal insolvency regimes, and the average costs incurred by individuals undertaking each process. However, Australian Financial Security Authority (AFSA) information on the number and nature of complaints received against personal insolvency practitioners may provide insight into whether the time and costs associated with personal insolvency regimes are problematic for insolvent business owners.

In 2013-14, AFSA received a total of 311 complaints against registered trustees (through either bankruptcies or personal insolvency agreements) (AFSA 2014a). While this number only relates to registered trustees, it represents a very small proportion (1 per cent) of the total 29 514 personal insolvencies (which includes those carried out by Official Trustees) during the period. Of these complaints, 30 (10 per cent) related to 'fees and costs'. AFSA found only 9 per cent of these complaints to be justified. During the same period, 51 (16 per cent) of complaints related to 'delays in administration or lack of action' and only 34 per cent of these were deemed justified.

This is consistent with the nature of complaints received by AFSA against registered debt agreement administrators over the same period. AFSA received a total of 24 complaints, representing just 0.2 per cent of the 10 705 total debt agreements undertaken in 2013-14. Of these complaints, just one related to 'fees and costs' and none were received regarding 'delays in administration or lack of action.'

These figures suggest that the time and costs associated with undertaking any personal insolvency administration are reasonable. However, caution must be taken when analysing data based on complaints. Complaints processes can be prescriptive, and it is difficult to judge whether the number of complaints received accurately reflects the number of actual issues. There may also be a conflict of interest, due to the fact that complaints regarding trustees were examined within the same profession, which may have discouraged the submission of some complaints (PC 2014a).

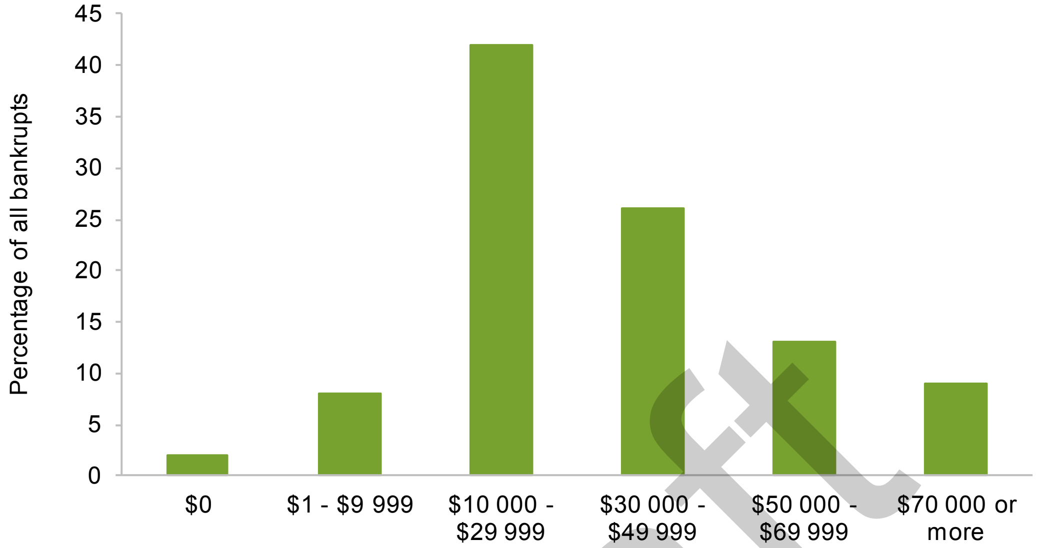
Value of assets and liabilities of debtors

While it is difficult to judge the impact of bankruptcy on economic activity and the extent of losses faced by creditors, there is some information available regarding the assets and liabilities of bankrupt debtors. The income earned by bankrupts in the year leading up to being declared bankrupt can be used as an indicator for the value of assets held by debtors (figure 13.4). In 2011, the majority of bankrupt debtors earned between $10 000 and $29 999 in the year prior to bankruptcy. This suggests that the majority of bankrupts are relatively low income earners, with a total of 52 per cent earning less than $30 000 the year before being declared bankrupt. In the 12 months prior to bankruptcy, fewer than 10 per cent of all bankrupts recorded an income greater than $70 000.

The unsecured debt level of bankrupts can be used to indicate the average value of liabilities owed by debtors (figure 13.5). Despite average incomes of bankrupt debtors being relatively low, 94 per cent of bankrupts had unsecured debts exceeding $10 000, whilst 77 per cent had unsecured debts exceeding $20 000 in 2011. A large proportion of these unsecured debts related to credit card liabilities (21 per cent). The other major sources of unsecured debt during the period were personal loans (12 per cent) and house mortgages (12 per cent).

The fact that most bankrupts possess unsecured debts exceeding their annual income suggests that losses faced by creditors who provide funds to bankrupts are likely to be, on the whole, high. Considering the number of personal insolvencies undertaken each year (nearly 30 000), they can affect a wide range of parties beyond the debtors. The existence of an efficient and effective legal framework for resolving personal insolvencies is therefore highly important.

Figure 13.4 **Income earned by bankrupts in the 12 months prior to bankruptcy**
2011



Source: ITSA (2012)

Figure 13.5 **Unsecured debt level of bankrupts**
2011

Source: ITSA (2012)

13.2 Legal framework for personal insolvency

Australia's personal insolvency regime serves multiple purposes. The legislation aims to allow debtors to be relinquished of their debts, while forfeiting their assets, and to ensure the protection of creditors and the community.

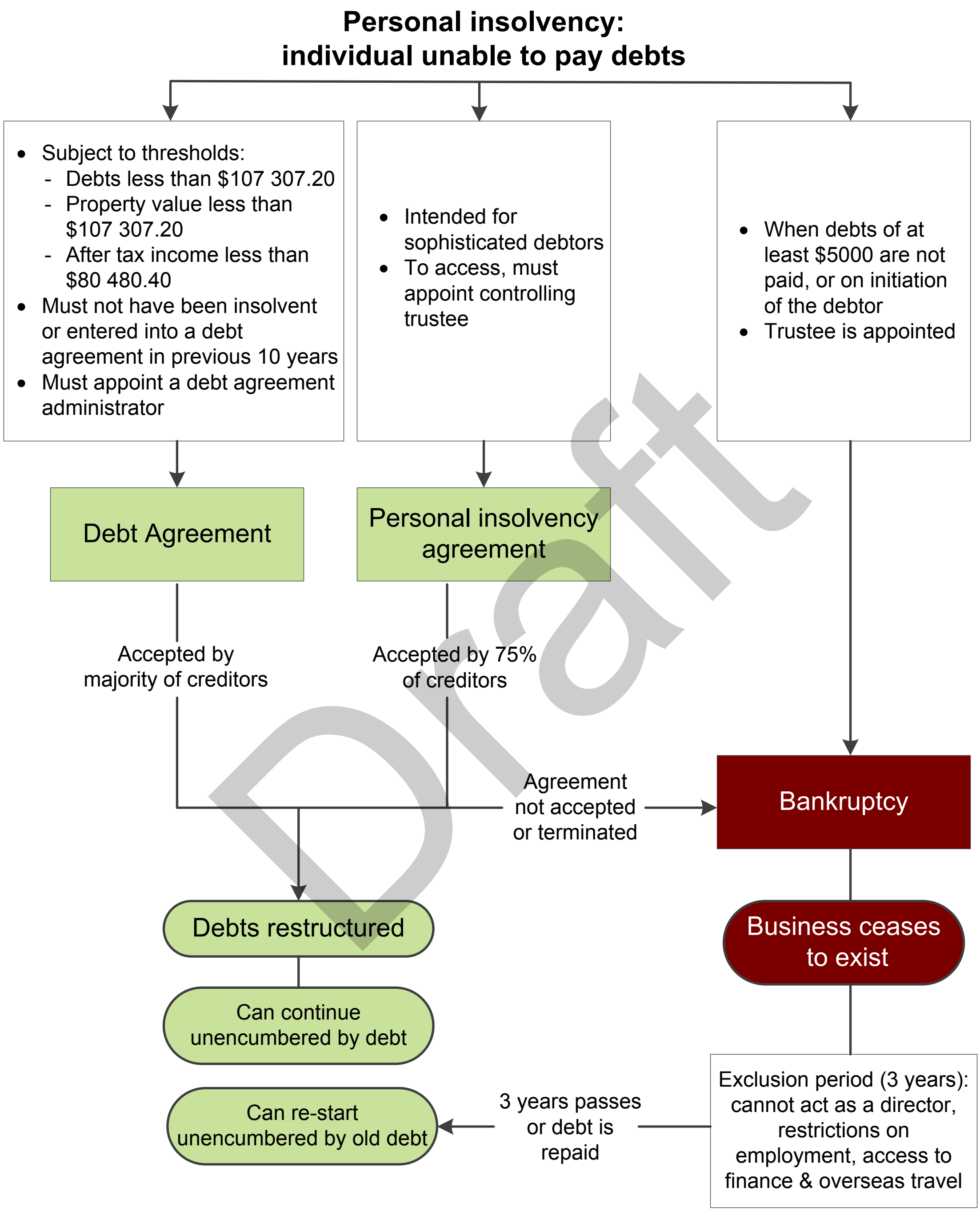
While corporate insolvency is governed by the *Corporations Act 2001* (Cth), personal insolvency of individuals is regulated by the Commonwealth[38] under the *Bankruptcy Act 1966* (Cth) (Bankruptcy Act).

Under the Bankruptcy Act, there are three main insolvency administrations available to individuals, each with their own distinct characteristics. These are bankruptcy, Personal Insolvency Agreements (PIAs) and debt agreements. Debt agreements and PIAs are relatively new options for dealing with personal insolvency in Australia, made available through amendments to the Bankruptcy Act in 1996 and 2004 respectively. In general, these alternatives impose fewer restrictions on debtors and their finances than the more traditional bankruptcy regime.

As it relates to business, the personal insolvency regime can either afford the individual the opportunity to restructure their debt (and if possible, continue their business) or can result in them becoming bankrupt — a process that would include the sale of the business and most (or all) of the associated assets. The criteria for each type of personal insolvency administration, and their interaction with each other, are depicted in figure 13.6.

[38] Personal insolvency is covered by Commonwealth law, but some related issues may tend to State law. For example, enforcing a contract that led to an individual being in debt.

Figure 13.6 **Options for personal insolvency and restructuring**



Not all paths are mutually exclusive
Green: Business may still trade
Red: Business cannot trade

Bankruptcy

If an individual is unable to pay their debts and cannot come to an arrangement with creditors, there are two alternatives for entering into bankruptcy. A debtor may choose to initiate bankruptcy by filing a petition with an Official Receiver[39] through the Australian Financial Security Authority (AFSA). In this instance, the debtor must also lodge a statement of affairs.[40] Alternatively, a creditor may take action to have an individual declared bankrupt by order of the court, under a sequestration order.[41] This can only occur if an individual's aggregate debts exceed $5000.

When an individual is declared bankrupt, a trustee is appointed to administer the bankruptcy process. A trustee can be either a privately appointed trustee licensed by AFSA, or an Official Trustee in Bankruptcy appointed through AFSA. Trustees are responsible for the determination and paying out of creditor's claims, and have the power to control and sell assets owned by the debtor in order to achieve this. The vast majority of the debtor's property comes under the control of the trustee upon declaration of bankruptcy, including 'after-acquired property' (property acquired by the bankrupt after the date of bankruptcy). Exceptions include physical tools used by the bankrupt in earning income, cars or other means of transport with a total value below $7500, and certain types of household property (*Bankruptcy Act 1966* (Cth) s 116).

Despite trustees being primarily responsible for the administration of the bankruptcy process, debtors have a number of obligations under the Bankruptcy Act. Firstly, debtors are required to provide any books (including accounts, documents and other records) to the appointed trustee, along with their passport. Whenever reasonably required, the debtor must also attend to the trustee, and may be obliged to attend meetings of creditors. Debtors must also provide the trustee with any relevant information regarding their conduct and examinable affairs, whilst also disclosing any information regarding divisible property[42] that is acquired after the date of bankruptcy. Overall, a debtor has a legal responsibility to assist in the bankruptcy process 'to the utmost of his or her power' (s 77).

In addition to these requirements, a number of sanctions are imposed on bankrupt individuals, designed to protect creditors and the community (box 13.1). A bankrupt

39 The Official Receiver is an office created under the Bankruptcy Act to carry out statutory functions under that Act, including maintaining the National Personal Insolvency Index (NPII), providing registry services in relation to personal insolvency, and assisting trustees to perform their functions though the issue of statutory notices (AFSA 2015d).

40 When a debtor becomes bankrupt or enters into a debt agreement or personal insolvency agreement, he or she must complete a statement of affairs that truthfully discloses all relevant details about their current financial position. This includes details of all debts, as well as details about current and recently owned assets (AFSA 2015d).

41 A sequestration order is an order made before a Registrar of the Federal Court, a Judge from the Federal Circuit Court or a Judge in the Federal Court making a person bankrupt based on a creditor's petition or other application as outlined under the Bankruptcy Act (AFSA 2015d).

42 Divisible property is property which can legally be sold in bankruptcy by the trustee (AFSA 2015d).

individual may also be required to pay the trustee a direct contribution from their personal income if their gross income exceeds a predetermined amount, calculated as part of an initial assessment following the declaration of bankruptcy (s 139P). The base income threshold amount above which contributions are required is $53 653.60 (net of tax). This figure is indexed for inflation and is updated twice per year (AFSA 2015e). This amount may be adjusted under certain circumstances, such as when a dependent of the debtor suffers from an illness or disability involving ongoing medical expenses (s 139T).

Box 13.1 **Restrictions on bankrupts**

A bankrupt individual is forbidden from travelling overseas without first obtaining written permission from the trustee. If the trustee is an Official Trustee registered through AFSA, the debtor is required to pay an application fee as part of this process. If permission is not reasonably and swiftly granted, these restrictions may impose an unnecessary burden on bankrupt individuals aiming to travel for legitimate purposes, or for reasons potentially beneficial to creditors, such as part of a condition of employment.

Debtors also face various restrictions when attempting to access finance or borrow money. Bankrupt individuals are required to disclose their bankruptcy if applying for any form of credit above an indexed amount, which was set at $5398 in March 2015 (updated quarterly). In addition, a debtor's bankruptcy will be identified on a public record known as the National Personal Insolvency Index (NPII), for the remainder of the life of the debtor. The fact of a debtor's bankruptcy status will also appear on their credit report for five years, a length of time that may extend past the actual bankruptcy period. These records of debt history, along with the direct limit on the size of allowed loans, make the process of accessing capital very difficult for debtors. This is a deliberate outcome as a result of the design of current bankruptcy policy, but can be seen as an obstacle to the financing and set-up of new businesses.

During the bankruptcy period, debtors are also restricted in terms of employment. The Bankruptcy Act does not directly prevent bankrupt individuals from seeking employment, however many professional associations and licencing authorities impose specific conditions and limitations on bankrupt members (AFSA 2015c). For example, a New South Wales building licence may not be granted or renewed to an individual who has been bankrupt within the previous three years. Similarly, in all states and territories, an undischarged bankrupt is incapable of sitting as a member of parliament, and will not be able to obtain a liquor licence.

Bankrupt debtors are not required to disclose their bankruptcy status when applying for a new job. However a prospective employer is entitled to ask for this information from a job applicant, or to search the NPII directly (QUT, sub. 26, p. 5). Debtors are also prevented from administering trust accounts without the permission of the court. The Bankruptcy Act also prohibits debtors from acting as the director or manager of a company during the bankruptcy period.

Bankruptcy can end through ether discharge or annulment. A debtor will be automatically discharged from bankruptcy if three years have passed since a statement of affairs was filed (s 149). However, this three year period can be extended to either a five or eight year period if the trustee objects to the discharge, with the extension depending on the specific grounds for objection. For example, the period of bankruptcy can be extended to eight years if a debtor fails to provide relevant property and income details, pay compulsory income contributions, or disclose a liability that existed before the bankruptcy period (s 149).

Alternatively, a bankruptcy will be annulled if either:

- all of the bankrupt's debts are paid in full, including any fees owing to the trustee; or
- the court finds that a debtor's petition should not have been presented, or a sequestration order should not have been made; or
- the debtor puts forward a proposal to pay their debts which is accepted by creditors.

In each case, the bankruptcy period is considered terminated. Following this, the debtor is still liable to pay some debts, such as those incurred after the bankruptcy period began, and to continue to assist the trustee in the realisation and distribution of property (s 153), but is otherwise free of restrictions and pre-existing debts.

Personal insolvency agreements (PIAs)

A personal insolvency agreement (PIA) can allow an insolvent individual to settle debts without declaring bankruptcy (*Bankruptcy Act 1966* (Cth) part X). Unlike bankruptcy, a PIA allows creditors to have some influence over the terms in which debts will be repaid. In most cases, a PIA will allow debtors to settle debts for less than what is owed in exchange for providing creditors with a quick return. A quick return allows creditors to reinvest funds repaid by the debtor and therefore potentially increase their ultimate return. Unlike debt agreements, PIAs are available to debtors regardless of their income, and allow for relatively sophisticated debtors to come to an agreement with their creditors.

To initiate a PIA, a debtor must first appoint a controlling trustee, and provide the trustee with a statement of affairs and proposal for authority. Once appointed, a trustee will take control of the debtor's property, and will undertake an investigation into the debtor's assets and income in order to prepare an independent report to creditors. Within 25 working days (30 if in December) of receiving a proposal for authority from the debtor, the trustee is required to organise a meeting of creditors. Creditors are given at least 10 days' notice of the meeting, and are then required to lodge a statement of claim.

At the meeting, the controlling trustee will propose a PIA on behalf of the debtor. The PIA sets out various conditions regarding how the debtor plans to repay their debts. For instance, a debtor may propose to pay creditors in either part or full, and through either instalments or a lump sum. After considering the details of the proposed PIA, creditors are then given the chance to vote in regards to accepting the proposal. The PIA will be accepted if creditors reach a 'special resolution,' where creditors representing at least 75 per cent of the dollar value of the voting creditor's debts vote in favour of the PIA. If accepted, the PIA legally binds all creditors and the debtor.

A PIA will come to an end when all obligations have been met by the debtor. However, a PIA can end early if:

- an event specified in the PIA as justifying termination takes place;
- the trustee is satisfied that the debtor is failing to meet their obligations, and the creditors agree that the PIA should be terminated; or
- termination is ordered by the court.

If a PIA is terminated early and the obligations have not been met by the debtor, they may be forced to enter bankruptcy. Appointing a controlling trustee is considered an 'act of bankruptcy', and a creditor can therefore apply to the court to make the debtor bankrupt if an attempt to undertake a PIA fails (s 40). After a PIA has ended, the debtor may request the trustee to provide a certificate of discharge in order to gain formal proof that all obligations have been met.

Debt agreements

Debt agreements are designed to provide debtors that have relatively low incomes with an informal and inexpensive alternative to bankruptcy. As with a PIA, a debt agreement can allow an insolvent individual to settle debts without declaring bankruptcy (*Bankruptcy Act 1966* (Cth) part IX), but a debt agreement is nevertheless considered an 'act of bankruptcy.' Such a contract involves an agreement by creditors to accept a sum of money which the debtor can afford, as payment for their debts.

Unlike PIAs, there are a number of restrictions regarding the eligibility of a debtor to enter into a debt agreement. For example, an insolvent individual can only propose a debt agreement if they:

- have not entered into a debt agreement, proposed a PIA or been bankrupt in the previous ten years
- possess unsecured debts of less than \$107 307.20[43]
- hold property with a current market value of less than \$107 307.20
- earn an after tax income of less than \$80 480.40 (AFSA 2015e).

To initiate a debt agreement, a debtor will commonly appoint a registered debt agreement administrator. Debt agreement administrators provide advice, calculate a budget, and communicate with creditors, and are remunerated as determined in the debt agreement itself. The debt agreement administrator will assist the debtor in developing a debt agreement proposal, which sets out the amount and timing of repayments offered to creditors. This proposal, along with a statement of affairs and explanatory statement, must be lodged with an Official Receiver.

[43] Figures were released 20 March 2015. They are indexed for inflation and updated twice a year by AFSA.

The Official Receiver will then inform creditors of the proposed debt agreement, and will send copies of the relevant forms to each creditor. Creditors are then given a chance to vote on the proposal. The debt agreement will be accepted if creditors representing the majority of the dollar value of the voting creditor's debts vote in favour of the agreement. If accepted, the debt agreement becomes legally binding, and creditors are paid in proportion to their debts. Secured creditors retain the right to seize and sell any assets which the debtor has offered as security for credit if the debtor is in default, however unsecured creditors cannot take any action against the debtor to recover their debts until the debtor defaults.

A debt agreement will come to an end when all obligations have been met by the debtor. However, a debt agreement can be terminated early if:

- the circumstances of the debtor change, and they lodge a proposal to terminate the agreement
- the debtor falls over six months into arrears
- the debtor becomes bankrupt
- termination is ordered by the court.

After termination, creditors can recommence action to recover debts, or seek to have the debtor declared bankrupt.

If all obligations of a debt agreement have been met, the Official Receiver will give the debtor a certificate, officially recognising that the agreement has ended. The debtor is entitled to any surplus property[44] after meeting all obligations of the agreement (s 185n).

Alternatives to bankruptcy

There are a number of advantages of undertaking a personal insolvency agreement or debt agreement rather than utilising the traditional bankruptcy regime.

- Under either agreement, debtors are permitted to travel overseas, for business reasons or otherwise, and will be able to keep financed assets (such as cars) as long as the conditions of the agreements are upheld.
- All interest and charges on unsecured debts are frozen.
- Debtors can make regular single payments instead of juggling multiple repayments. For instance, these agreements can allow debtors to repay their debts through a periodic payment plan or lump sum arrangement.

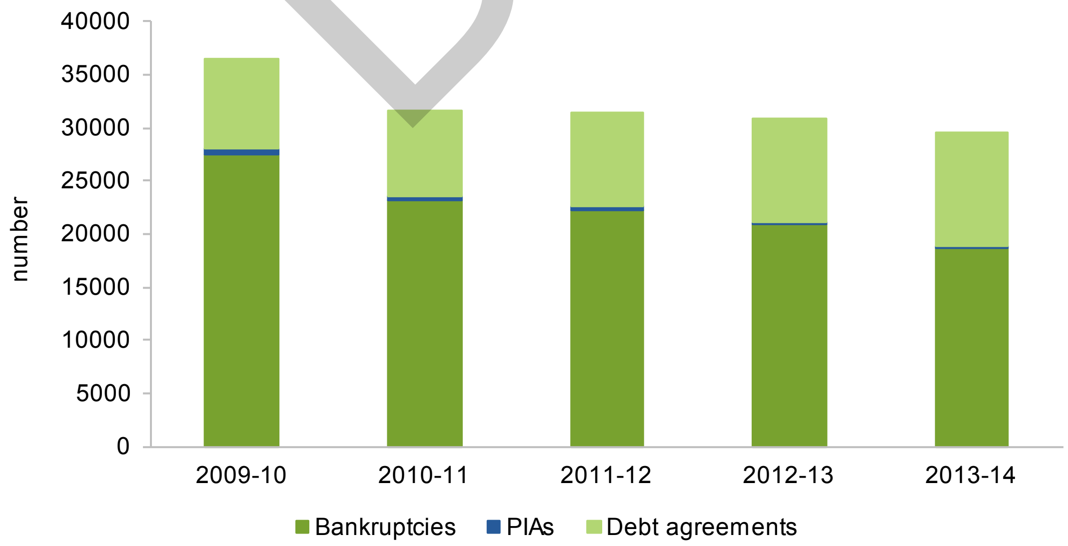
44 When a debt agreement ends under subsection (1), the debtor is entitled to any property that was subject to the debt agreement but was not required by the agreement to be distributed to creditors (s 185n).

- Each agreement is flexible and can be constructed to suit the debtor (and creditors). Debtors may propose a moratorium, lump sum settlement or other arrangement to repay their debts, which can be based upon what a debtor can actually afford to pay.
- Debtors have the opportunity to continue to act as a director or carry on business.
- Debt agreements and PIAs allow debtors to avoid the 'stigma' attached to bankruptcy.

The most commonly used method for dealing with personal insolvency in Australia is bankruptcy. During 2013-14, there were over 29 500 personal insolvencies recorded in Australia (AFSA 2014e). Of these, bankruptcies were the most commonly utilised form (18 601), followed by debt agreements (10 705) and PIAs (208) (AFSA 2014e). As a proportion of all personal insolvencies and in absolute terms, bankruptcies have declined over the past five years, whilst use of debt agreements has increased to unprecedented levels (figure 13.7). These trends suggest that the agreement alternatives to bankruptcy may have been underutilised previously but are becoming more popular.

The relative popularity of debt agreements in comparison to PIAs may be due to a number of factors. It is likely that the eligibility requirements of applying for a debt agreement can be satisfied by most personally insolvent debtors. As discussed earlier, the vast majority of debtors earn income of less than the threshold amount of $80 480.40 (figure 13.4) and possess unsecured debts below the $107 307.20 threshold (figure 13.5). It is also easier for a debtor to gain approval for a debt agreement. The majority of creditors, rather than 75 per cent in the case of PIAs, are required to vote in favour of the agreement.

Figure 13.7 **Personal insolvency regimes in Australia**



Source: AFSA (nd)

13.3 Issues in personal insolvency

Despite the existence of alternative paths for individuals going through personal insolvency, a number of potential issues with Australia's personal insolvency regime have been identified. These issues are outlined below.

Separate regimes for personal and corporate insolvency

As personal and corporate insolvency are governed under separate Acts in Australia, each regulatory framework imposes differing — and sometimes contradictory — obligations. A number of previous Australian reviews and inquiries have made recommendations on the harmonisation of personal and corporate insolvency regimes. These include the 1988 *Australian Law Reform Commission Report 45* (Harmer Report), the 2010 *Senate Economics References Committee Report on Insolvency Practitioners* (Senate Inquiry Report), the 2014 *Financial System Inquiry* (Murray Inquiry), and the consultation process for the current 2014 *Insolvency Law Reform Bill*. Inconsistencies between the forms of insolvency were also identified by the Australian Government as potential sources of inefficiency and complexity, and reform of Australia's insolvency industry was proposed to address the inconsistencies (Australian Government 2011).

A number of potential benefits of unifying the two legal regimes have been identified. A more streamlined approach to insolvency legislation may result in cost savings. Currently, the Australian Financial Security Authority (AFSA) and the Australian Securities and Investments Commission (ASIC) have separate responsibilities for the regulation and administration of the two regimes. If implemented, a merger between the regulators could reduce administrative costs and create economies of scale. It may also be desirable from a policy consistency perspective for insolvency law to be controlled by a single government agency (Australian Government 2014a).

Under the current framework, certain cases of business failure may be covered by both the corporate and personal insolvency regimes (Australian Government 2014a), which may lead to complexity and confusion for insolvency administrators and individual debtors. A unified scheme could alleviate these issues.

The overlap can arise in a number of ways. Most simply, a small company's insolvency could send its director(s) bankrupt in the same process. It is common for directors to personally guarantee to repay debts where the company is unable to do so, in order to obtain finance from creditors (Clifford 2012). This removes the 'liability shield' otherwise provided through incorporation, and the corporate insolvency of a company may therefore lead to the personal insolvency of a director (Armour and Cumming 2008). A director may also become personally insolvent in the event of insolvent trading during the course of a corporate insolvency.

The current dual scheme for dealing with insolvency in Australia is a contrast to the more uniform schemes in other jurisdictions. For instance, the United Kingdom introduced legislation unifying personal and corporate insolvency provisions in response to the 1982 'Cork Report'. The insolvency regime in the United States is covered by its Bankruptcy Code, which also encompasses both forms of insolvency in a single piece of legislation. Other examples of countries with combined personal and corporate insolvency frameworks include New Zealand, Canada, Singapore and Hong Kong (Australian Government 2014a).

There is a range of options for moving towards a more uniform insolvency framework. A conservative approach could focus on specific areas of the law, such as those outlined in the Government's 2014 *Insolvency Law Reform Bill Exposure Draft* (ILRB). For example, the ILRB proposes the alignment of qualification and experience requirements of insolvency practitioners. The Bill also allows creditors in both regimes to more easily replace administrators and liquidators. This aims to bring corporate insolvency in line with bankruptcy laws, where creditors have the ability to replace the trustee by resolution (*Bankruptcy Act 1966* (Cth) s 180).

Alternatively, a much larger reform could involve a complete merging of personal and corporate insolvency regimes. Such a large-scale legislative change would result in significant administrative costs associated with drafting legislation and the creation of, or consolidation in, a new regulator. Furthermore, it has been suggested that since differences between natural persons and corporations exist, having separate legislation can be valuable for distinguishing these differences (Australian Government 2014a). No concerns have been expressed by either individuals or companies in relation to Australia's dual insolvency framework (PC 2010). For these reasons, the benefits of such a change would need to be clearly articulated, and demonstrated to exceed the costs, before the change is implemented.

At this time, the Commission remains to be convinced that the net benefits from further consolidating regulation, particularly from merging the regulators, would be any more than marginal. Therefore, the Commission considers that the Government should maintain the overall insolvency framework, but should aim to align the requirements under personal and corporate insolvency laws where possible and practicable.

Exclusion periods and restrictions for bankrupts

In order to protect creditors and the community, a number of sanctions are imposed on bankrupt individuals (box 13.1). These have the potential to significantly hinder the ability of an individual to conduct business activity and can (deliberately) be barriers to business set-up.

These penalties and restrictions deliberately prevent bankrupt individuals from undertaking the commercial and consumer behaviour they practiced before becoming bankrupt. They are intended to ensure that bankrupts do not flee obligations (overseas travel restrictions), incur further debts (financial restrictions) and to ensure that consumers are not unduly exposed to bankrupt service providers (licencing and employment restrictions). However, the prohibition on company directors may only be valid in certain circumstances.

As ARITA (sub. 31, p. 24) suggested, such a restriction may be blunt, since an individual who becomes bankrupt due to personal or consumer reasons will be disqualified from operating a business in the same way as a disreputable corporate director. Given that the insolvency framework is designed to protect creditors whilst encouraging entrepreneurship, there may be circumstances where allowing a bankrupt to operate as a director is appropriate.

For example, an individual may become bankrupt due to an unforeseeable, personal transaction that is not related to the running of a business. In this case, it may be optimal for the bankrupt debtor to have the ability to appeal to AFSA in order to have the director's 'exclusion period' removed. In the interests of creditors, and consistent with current laws, such individuals should be legally obliged to disclose their bankruptcy status. While the Commission agrees in principle that exclusion from directorship is a blunt regulatory tool, it concludes that more information regarding the potential outcomes of such a reform is required before any change can be recommended. Accordingly, the Commission is seeking participants' views on the possibility of bankrupts operating as directors under certain circumstances.

INFORMATION REQUEST

Are there circumstances where it would be appropriate for a bankrupt to continue as a company director? If so, what framework would be required? How could the interests of creditors (of the individual and any affected company) be appropriately protected while still allowing the bankrupt to work as a director?

As highlighted previously, the period of bankruptcy commonly spans three years, but may be extended to a five or eight year period under certain circumstances. Previously under Australian law, debtors could apply for early discharge of bankruptcy. However these provisions were removed from the Bankruptcy Act in 2003. Therefore, the restrictions highlighted above will apply to a bankrupt individual for at least three years, unless the bankruptcy is annulled.

It has been argued that such an extended period of bankruptcy may have negative economic consequences. For instance, potential business owners may be deterred by the fact that individuals are forced to endure a lengthy 'exclusion period' before recommencing business activity following bankruptcy. These restrictions on bankrupt individuals may encourage the use of limited liability company structures. This could lead to a distortionary outcome, where entrepreneurs strategically select the structure of their business to avoid the personal insolvency framework rather than to maximise profit (QUT, sub. 26, p. 2). In addition, more onerous restrictions on bankrupts may increase the 'risk tolerance' required by entrepreneurs considering starting a business (Armour and Cumming 2008). Longer bankruptcy periods may therefore discourage 'latent' potential business owners who are risk averse from entering the market. It is therefore important to carefully balance the competing policy goals of protecting creditors and encouraging entrepreneurship when determining the optimal duration of the company director exclusion period.

In 2004, the United Kingdom altered their bankruptcy laws by reducing the exclusion period from three years to one year (box 13.2). Under current UK bankruptcy law, insolvent debtors are automatically discharged from bankruptcy at the conclusion of this period, requiring the completion of no paperwork, and even if no payments have yet been made to creditors (UK Government 2015). However, it is important to note that, under current UK law, the court has the power to extend this period to up to eight years if debtors do not carry out their duties, or if they are found to have acted carelessly or dishonestly (UK Government 2015).

The reduction of the UK automatic discharge period was intended to remove the stigma of bankruptcy, encourage failed entrepreneurs to attempt new business ventures, and allow bankrupt individuals to attain quick financial rehabilitation. It has been suggested that, even in the case of consumer bankrupts, there are public benefits to be gained from quickly and efficiently removing restrictions on bankrupt individuals and enabling further consumption to take place (ARITA, sub. 31, p. 24). Lenient bankruptcy laws may increase the risk associated with lending and therefore the cost of capital in the economy, however retaining regulatory oversight should minimise such risks.

Laws permitting the discharge from bankruptcy were first introduced in the Netherlands in 1997 and Germany in 1998. The move towards more lenient bankruptcy laws in these countries coincided with an increase in the average level of self-employment of 4.3 per cent and 4.5 per cent respectively (Armour and Cumming 2008). Given these potential benefits, it would make sense to consider the implementation of a shorter exclusion period for bankrupts in Australia. The Commission acknowledges, as suggested by submissions to this inquiry, that such a change reduces the time available to creditors to claim debts, which could be problematic for maintaining the integrity of Australia's insolvency regime (ARITA, sub. 31, p. 24). However, such concerns are outweighed by the potentially large economic benefits of a more lenient bankruptcy law (Armour and Cumming 2008), and may be avoided through stringent supervision by AFSA and of the courts to increase exclusion periods in a manner more targeted at misconduct. Considering this, and observing the success of implementing such a change in the UK, a reduction in the 'exclusion period' imposed on bankrupt individuals appears justified. Similar to reforms made in the UK, the trustee should retain the power to apply to the court to extend the bankruptcy period to up to eight years under certain circumstances, to ensure that creditors can have confidence that debtors will carry out their required duties.

Box 13.2 **Reforms to bankruptcy law in the UK**

Through the *Enterprise Act 2002* (UK), the United Kingdom introduced a number of reforms to its personal insolvency regime. The overall aims of these reforms were to encourage 'responsible' risk taking, allow viable businesses to be rescued, and to improve fairness and certainty for all stakeholders involved in the bankruptcy process (UK Government 2001). In line with this Act, the UK altered a number of bankruptcy laws in 2004.

A key change implemented by the UK Government involved amending the *Insolvency Act 1986* (UK) in order to reduce the duration of bankruptcy. The Enterprise Act stipulates that:

> A bankrupt is discharged from bankruptcy at the end of the period of one year beginning with the date on which the bankruptcy commences.

Prior to these reforms, debtors would typically be discharged three years after commencing bankruptcy.

Many of the reforms introduced by the Enterprise Act resulted in benefits for business owners and entrepreneurs. The reduction of the automatic discharge period led to a more 'forgiving' bankruptcy law, and has allowed entrepreneurs to re-enter the economy more quickly following business failure (Armour and Cumming 2008). It has been shown that laws encouraging a 'fresh start' for failed business owners, such as those in the United Kingdom, promote business start-ups through repeat entrepreneurship, and increase business entry at the margin. In addition, in jurisdictions where no fresh start is offered to bankrupts, the introduction of such a policy is associated with an increase in the average rate of self-employment of around 3.8 per cent (Armour and Cumming 2008). These reforms have also led to a reduction in the stigma attached to bankruptcy.

Another aim of the Enterprise Act was to provide a 'robust and effective remedy' against debtors who abuse their creditors, by implementing tougher restrictions on 'irresponsible' or 'reckless' bankrupts (UK Government 2001). Under current UK bankruptcy law, the court has the power to extend the automatic discharge period to up to eight years if debtors do not carry out their duties, or if they are found to have acted carelessly or dishonestly (UK Government 2015). This has allowed for a targeted distinction to be made between bankrupts on the basis of their culpability, and encouraged honest failed entrepreneurs to attempt new business ventures.

As previously mentioned, bankrupts may face restrictions in terms of their employment (box 13.1). The nature and length of these restrictions are inconsistent across jurisdictions and occupations, and the implementation of this recommendation may add to this. Reducing this inconsistency may provide some benefits, however restrictions extending beyond the period of bankruptcy may be justified in certain circumstances. For instance, where a breach of State law or other criminal activity has occurred, imposing extended restrictions on certain individuals may be in the public interest.

As such, following the implementation of the Commission's recommendation, professional associations and state and territory governments (with the involvement of relevant licencing authorities) should re-examine the length of any restrictions on employment currently enforced, with a view to justifying any differences — for particular circumstances (for example breaches of other State laws or criminal activity) and defined policy objectives — with the one year exclusion period recommended by the Commission.

DRAFT RECOMMENDATION 13.1

Section 149 of the *Bankruptcy Act 1966* (Cth) should be amended so that, where no offence has occurred, individuals are automatically discharged from bankruptcy one year following the filing of a statement of affairs.

The trustee, and the courts, should retain the power to extend the bankruptcy period to up to eight years if there are concerns regarding the debtor's conduct or ability.

The Australian Government should work with other governments and professional bodies to ensure that any regulations or other arrangements restricting the employment of bankrupts beyond the period of bankruptcy are justified according to specific and efficient policy objectives.

Asset siphoning and protection

As part of any personal insolvency process, the insolvent debtor is required to disclose information regarding their income and assets. In certain cases there may be an incentive to under-report the value of the debtor's assets, since this may reduce the amount required to be paid to creditors by the debtor. One strategy to reduce debt repayments is the siphoning of assets, which involves dishonestly transferring assets from one party to another for the sole purpose of manipulating financial records.

Siphoning of assets can be an issue in the small and medium business sector, and in large businesses where directors have personal liability. Anecdotal evidence suggests that some business owners siphon their assets to related entities (such as their spouse or children) before becoming insolvent (Worrells 2013). The prevalence of such behaviour may undermine the confidence of creditors in the current insolvency framework, and could therefore hinder the efficient exit of businesses.

Similarly, it has been argued that individual business owners often deliberately take action to separate their assets through various business structures. For instance, business owners may use a trust structure in an attempt to protect their personal wealth, and ensure their financial security if the business fails (see chapter 4). This has the potential to prevent creditors from recovering the full value of provided funds, and may therefore discourage creditors from funding entrepreneurs hoping to start a business. The issue of whether a trustee should be able to 'pierce' trust structures in order to determine the actual asset ownership of debtors has been the subject of much debate (ARITA, sub. 31, p. 25).

A related technique used by business owners is 'income splitting', whereby an individual, as a legal fiction, attributes part of their own income to a spouse, other individual, or entity such as a trust or company (The Treasury 2015b). This can allow individuals to report falsely low income levels, and is used primarily as a means of reducing income tax requirements. This strategy could also be used in the context of personal insolvency, as certain restrictions on bankrupts are dependent on their reported income. Income splitting is considered in greater detail in the Australian Government's 2015 White Paper on the Reform of Australia's Tax System.

The Bankruptcy Act prevents individuals from diverting assets to related entities once insolvent, but does not limit the restructuring of assets prior to insolvency. This may be problematic, as company directors may have the ability to strategically siphon assets if their business is predicted to become insolvent in the near future. One way the Bankruptcy Act may be able to prevent this occurring is through the existing requirement of debtors to fully disclose and explain any loss or transfer of assets in the 2 year period preceding bankruptcy (*Bankruptcy Act 1966* (Cth) s 265). Failure to disclose this information may result in a one year imprisonment.

However the issues highlighted above may relate more to problems with trust structures, and other broader areas of law and enforcement, particularly in relation to tax, rather than the personal insolvency framework itself. Before recommendations can be made, more information regarding the current means of preventing the siphoning of assets is required. Accordingly, the Commission is seeking participants' views on the adequacy of the current framework to prevent asset siphoning.

INFORMATION REQUEST

What means are currently available to investigators, regulators and courts to prevent, detect and undo asset siphoning? Are these sufficient? Are other means necessary, and if so, what reforms are needed? Are these matters best dealt with in terms of personal insolvency, or in broader contexts such as tax reform?

14 Corporate insolvency: frameworks

Key points

- The corporate insolvency system performs an important economic role, facilitating exits, doing so in a manner that provides procedural certainty to creditors and encouraging orderly processes rather than a rush to dismantle a company in a piecemeal manner.
- The objective of the corporate insolvency system should be to provide genuine opportunity for restructure, and where that is not possible, to provide an expedient, effective and orderly process for winding up a company.
- The current process contains three main streams, voluntary administration, liquidation and receivership. However, in recent years much restructuring work has been undertaken through informal workouts as companies seek to avoid the stigma of the formal process and (secured) creditors seek to improve the likelihood of their ongoing capital returns.
- International data, and the Commission's consultations, suggest that Australia's insolvency system performs relatively well, and does not require wholesale change.
  - In particular, wholesale adoption of the United States' 'chapter 11' debtor in possession model is unwarranted.
- Nonetheless, there is scope for reform, particularly in relation to the timing and effectiveness of restructuring, and ensuring that the liquidation process is as expedient as possible.

Not all businesses succeed. Some are only intended to be temporary at their creation, others cease to exist due to personal, technological or external economic factors, some are poorly managed and others are victims of internal or external misconduct. Whatever the reason for a closure, its impacts typically extend beyond the owners of the business. As such, it is important that the process for winding up a business is orderly and efficient.

This chapter considers the objectives of the insolvency system and examines how the existing Australian insolvency processes meet these objectives. This comparison informs the Commission's consideration of the scope for reform of insolvency processes set out in chapter 15.

14.1 The economics of corporate insolvency

What, or when, is corporate insolvency?

The broad concept of corporate insolvency relates to companies in financial difficulty — be it temporary or terminal. In effect, 'financial difficulty' means that the company is struggling or unable to pay its creditors. However, the specifics of a definition of insolvency are mired in technicalities spanning three disciplines — accounting, economics and law (box 14.1). As such, the meaning of insolvency can vary depending on the context.

Box 14.1 Differing definitions — when is a company solvent?

Armour (2001, pp. 3–4) explained the different approaches to defining insolvency as they arise in accounting, economics and law:

> Balance sheet insolvency is an accounting concept …. It signifies that the book value of a firm's assets are less than those of its liabilities. It should be distinguished from so-called 'cash flow' insolvency; in which case a firm is unable to pay its debts as they fall due. In English law, such inability may be inferred from the fact that a company has failed to pay, on demand, a debt which is due. Financial economists commonly use the expression 'financial distress' to refer to the condition experienced by a firm which is having difficulty in paying its creditors. … Financial distress … is dependent on the structure of the repayments … and the nature of the assets available to satisfy them. Illiquid assets and large repayments may mean that a firm which is solvent in a balance-sheet sense cannot pay its debts as they fall due. …
>
> Solvency should be distinguished from economic viability ... Insolvency is concerned with the relationship between a firms assets or cash flows, and the amount of debt in its financial structure. Viability is a function of the net present value of its business as a going concern. Provided that the business has a going concern value which is greater than the value of its assets sold on a break-up basis, and also greater than zero, then it is economically viable. In other words, its assets are being put to their highest-valued use. Lack of economic viability is referred to as 'economic distress'. This condition is related to financial distress in the following way: all firms which are economically distressed will also become financially distressed. The reverse, however, is not true. A firm with an economically viable business may become financially distressed simply because it has taken on more debt than it can service.

In Australian law, s95A of the *Corporations Act* 2001 (Cth) ('the Act') defines insolvency as the opposite of solvent, where a person is solvent 'if and only if the person is able to pay all [their] debts, as and when they become due and payable'. This aligns with the 'cash flow' definition of insolvency used in English law. The existence of this definition alone has not been enough to eliminate uncertainty as to the precise timing, or 'moment' of insolvency.

Such definitions take on particular importance when legal liabilities become involved. A prominent example is a directors duty to prevent insolvent trading under s588G of the Act. In this case, the precise timing of a company's insolvency is a core component of establishing if a duty has been breached and/or an offence has occurred. Uncertainty about this timing can lead to directors initiating formal procedures earlier than may otherwise be necessary simply for fear of incurring liability (discussed in chapter 15).

While the Commission acknowledges that difficulties exist with the present definition, it considers these are largely inherent to the complexities of the area of law and the underlying commercial transactions involved. In discussing insolvency, the Commission has adopted the s95A definition. The issues that this can lead to are instead addressed by more targeted reforms (chapter 15).

The economic role of insolvency law

Insolvency is one particular form of business exit. As discussed in chapter 2, exits themselves perform an important role in the economy — contributing to increases in average productivity, facilitating structural change within and between industries and allowing entrepreneurs to learn and experiment, transferring skills and information between old and new businesses. It is important that an insolvency regime facilitates these exits in a structured, predictable and expedient manner to enable learning and adjustment following business exit without undue delay or cost.

Specifically, any insolvency system should allow for a restructured company to emerge from the process in a more efficient form, or where this this is not possible, expedient closure should allow for the redeployment of employees and capital to more productive uses.

In the absence of an insolvency system, there would be a 'race to court' under contract and debt collection laws whereby creditors have an incentive to be the first party to lodge action. This potentially results in other creditors receiving no returns, encourages early claims, and thereby inhibits opportunities for restructure. In order to 'win' the race to court, each creditor would also incur monitoring costs to continuously assess the solvency of the debtor.

However, if communication between the creditors is possible and transaction costs are sufficiently low, a group of individuals would achieve the most beneficial outcome by cooperating, or acting collectively. Where these conditions do not hold, the individuals will act on their own, to their collective detriment (Jackson 1986).

By appointing a single person to determine, realise and distribute the debtor's assets, a collective approach avoids: each creditor incurring monitoring costs, the transaction costs associated with reaching agreement between groups of creditors and the duplication of the costs of enforcing the debt. As Duns noted, a collective approach is also more likely to maximise the return to creditors and lead to some form of continuation of the business:

> This would occur where the sale of the debtor's assets on a going-concern basis would result in a greater return to creditors than a sale of the same assets on a piecemeal basis. A sale on a going-concern basis is unlikely to occur in the absence of an agreement among creditors. (2002, p. 9)

The insolvency system also has an enforcement role — detecting criminal activity that may have led to a business winding up. This enforcement provides a credible threat of detection of wrongdoing that is important to the overall confidence of creditors. This, in turn, affects creditor willingness to provide finance.

Characteristics of insolvent companies

Number of corporate insolvencies

As detailed in chapter 2 and appendix B, most exits are for small and medium, rather than large, businesses. While failures represents only a small fraction (less than 10 per cent) of all exits, what evidence there is suggests failures are also dominated by small and medium businesses. This is perhaps unsurprising, not only due to the large number of small businesses, but also due to some of their characteristics that make them more prone to relatively sudden exits. For example, there is often considerable 'key person risk' — a change in one person's life through illness, injury or death can also spell the end of a small company. Further, small businesses are typically less able to absorb losses and disruptions.

In relation to business exits (a broader concept than insolvency, discussed in chapter 2), small companies dominate the annual exit statistics. In 2013-14, companies employing less than five staff (including non-employing companies) accounted for 92 per cent of company exits, and companies employing less than 20 staff accounted for 98 per cent (ABS 2015c unpublished).

Specifically in relation to insolvency, the Australian Securities and Investments Commission (ASIC) reports indicate that, in 2013-4, 81 per cent of the 9459 initial external administrators' reports related to companies with fewer than 20 employees (2014f). In terms of liabilities, ASIC reports that 43 per cent of failed companies had estimated liabilities of $250 000 or less, and 76 per cent of failed companies had estimated liabilities of less than $1 million. While more a reflection of the poor financial state of a company than a measure of size at its 'peak', the remaining assets at the time of entering insolvency also suggest a dominance of small companies — 41 per cent are assetless at the time of insolvency, and a total of nearly 80 per cent have less than $50 000 assets at insolvency.

By industry, the 'Other' (business and personal) services (26 per cent), construction (23 per cent), accommodation and food services (9 per cent) and retail trade (9 per cent) industries together made up more than half of all companies entering insolvency in 2013-14. In contrast, relatively large industries such as mining, health care and education accounted for approximately 1 per cent of insolvencies each.

Nominated reasons for insolvency

Commonly, external administrators nominate two or three causes for failure rather than a single one. The most commonly nominated causes for failure in 2013-14 were inadequate cash flow or high cash use (43 per cent of reports, and common in the construction industry), poor strategic management of business (42 per cent), and trading losses (33 per cent), the latter two common in the accommodation and food services industries. While fraud (1.5 per cent) is only reported as a reason for failure slightly more commonly than natural disaster (1 per cent), this does not indicate that no wrong doing occurred in the lead up to companies' failure. Indeed, in 2013-14, 76 per cent of initial external administrators reports alleged possible misconduct, with an average of 2.5 breaches per report.[45]

Overall, the available data suggests that insolvencies are dominated by small companies that have exhibited poor management of cash flow and businesses strategies.

Objectives of the insolvency system

Current objectives

In terms of overarching objectives of insolvency law, a generally accepted (ARITA 2014b) summary of the 'fundamental principles' of insolvency law was provided by the last comprehensive review of insolvency laws in Australia, the 'Harmer Report' in 1988:

- The fundamental purpose of an insolvency law is to provide a fair and orderly process for dealing with the financial affairs of insolvent individuals and companies.
- The insolvency law should provide mechanisms that enable both debtor and creditor to participate with the least possible delay and expense.
- An insolvency administration should be impartial, efficient and expeditious.
- The law should provide a convenient means of collecting or recovering property that should be properly applied toward payment of the debts and liabilities of an insolvent person.
- The principle of equal sharing between creditors should be retained and in some areas reinforced.
- The end result of an insolvency administration, particularly as it affects individuals, should, with very limited exceptions, give effective relief or release from the financial liabilities and obligations of the insolvent.
- Insolvency law should, as far as convenient and practical, support the commercial and economic processes of the community.
- As far as is possible and practical, insolvency laws should not conflict with the general law.
- An insolvency law should enable ancillary assistance in the administration of an insolvency originating in a foreign country. (The Law Reform Commission 1988, p. 2)

The breadth of these principles underscores the complexity of insolvency law, as well as the range of competing considerations that it must balance.

Many commentators have highlighted that, in comparison to overseas systems (box 14.2), a strong feature of the Australian system is a focus on the creditor in preference to the

[45] Such breaches include matters other than fraud, including breaches of directors' duties such as insolvent trading.

rehabilitation of the company. As the Australian Restructuring Insolvency and Turnaround Association (ARITA) noted:

> The Australian regime could currently be described as one with a strong bias towards preserving creditors' rights. Some other jurisdictions have more of a bias towards the preservation of the ongoing nature of organisations in financial distress. (ARITA 2014b, p. 5)

Box 14.2 **The objectives of overseas restructuring mechanisms**

The Australian insolvency system is generally regarded as creditor-focused. While this can be evidenced through the application of the insolvency procedure, it is also apparent by comparison with other countries.

The most common comparison is made with the chapter 11 bankruptcy process in the United States (discussed below). The objective of that system is to facilitate a reorganisation plan that has been proposed by the debtor to keep the business alive and pay creditors over time.

In Canada, the Companies' Creditors Arrangement Act aims to bring together creditors and principals of a company under court supervision in an attempt to reorganise, compromise or make an arrangement under which the company could continue in business (ARITA 2014b).

In the United Kingdom, the introduction of the Enterprise Act in 2003 heightened the focus on continuing the company as a whole, as Lord McIntosh of Haringey commented in the House of Lords during discussion of the Bill:

> Company rescue is at the heart of the revised administration procedure. We want to make sure that viable companies do not go to the wall unnecessarily … The emphasis on company rescue will create more incentive for company management to take action promptly and use the administration procedure before the situation becomes terminal. That is why the purpose directs the administrator first to perform his or her functions 'with the objective of rescuing the company'. (2002, column 766)

In contrast, the objectives of New Zealand's insolvency law focus on creating a predictable and simple regime to distribute proceeds to creditors, and to maximise return to creditors by encouraging early intervention. As the New Zealand Law Commission has noted, the underlying theme is one of certainty, focussing on:

> … the need to instil trust and confidence in a functioning insolvency law system. Once trust and confidence exists, the system can act as a pillar for both fiscal and social policy decisions. (2001, p. 6)

The Australian Institute of Company Directors (AICD) also argued that the Australian system was creditor-focused, sometimes at the expense of the possibility of recovery for the company:

> Australia's insolvency regime is focused on creditor outcomes. This approach is exemplified in the Exposure Draft of the Insolvency Law Reform Bill 2014 which increases the rights of creditors during a corporate insolvency event. In addition, much of the commentary around potential improvements to the regime over many years has centred upon identifying the best mechanisms to distribute the assets of distressed businesses rather than helping distressed businesses not to fail in the first place. (sub. 3, p. 2)

In particular, the focus on the return to creditors (even in voluntary administration), the degree of reporting to creditors and their ability to challenge various elements of the administration and liquidation processes are seen to favour the interests of creditors over the continuation of the company. Or, as others have put it, in contrast to Australia, systems such as the chapter 11 process United States put 'recovery ahead of burial' (Senate Economics References Committee 2014, p. 446).

Objectives of specific process within the insolvency system

Australia's insolvency system is broadly made up of three components: administration, liquidation and receivership. Each of these components has differing objectives.

The objective of Australia's system of voluntary administration, as stated by s435A of the Act is:

> The object of this Part is to provide for the business, property and affairs of an insolvent company to be administered in a way that:
>
> (a) maximises the chances of the company, or as much as possible of its business, continuing in existence; or
>
> (b) if it is not possible for the company or its business to continue in existence — results in a better return for the company's creditors and members than would result from an immediate winding up of the company.

In relation to liquidation, the objective was enunciated in a past parliamentary joint committee report:

> The objective of a winding up is to bring about an end to the corporations existence in an orderly and equitable manner that obtains the maximum return possible for creditors and members. (Parliamentary Joint Committee on Corporations and Financial Services 2004, p. 12)

Receiverships differ again, as receivers are typically appointed by a debtor. Therefore, the objective of a given receivership is to act in the interests of the secured creditor.

The Commission's view on insolvency system objectives

In the Commission's view, the role of the insolvency system should be to encourage economic activity through the productive use of assets — be it the continuation of existing (valuable) activity, or the rapid and orderly redeployment of employees and capital to other activities. There are a number of stakeholders affected by both the continuation of a business or the redeployment of employees and assets — owners, creditors, employees, customers and other businesses such as suppliers. Not all of these interests will necessarily be aligned with those of secured creditors in particular when a business is struggling. In this light, an undue focus on the rights of creditors at every stage of the process (a perceived feature of the current Australian system) can risk diminishing the overall economic value of the process. Instead, a more balanced group-focused process may provide the best opportunity for restructuring, and the best overall outcome in the long run.

Therefore, the objective of the insolvency regime should be to provide a genuine opportunity for restructure, without providing incentive for strategic behaviour by debtors and creditors. If restructure is not possible, the insolvency system should aim to provide an efficient, effective (and expedient and inexpensive) and orderly process for winding up the company, including consideration of creditors and provide certainty for future process. The regime should foster a coordinated approach to recovery of a company, or its assets.

The Commission acknowledges the importance of an enforceable system of rights. Nonetheless, the Commission's view of the appropriate objectives differs from the current system in its preference for speed and effectiveness over absolute certainty of enforcement of all rights. The Commission's approach to analysing and recommending reforms below and in chapter 15 is guided by these objectives.

14.2 Restructuring processes in Australia

The insolvency process can be thought of as in two broad stages. First, when there is some prospect of salvaging a company or components of it, informal workouts, voluntary administration (including deeds of company arrangement) and schemes of arrangement exist to allow a company to restructure and attempt to continue as a viable entity.[46] Second, where a company has no realistic prospect of recovering from financial difficulties, and is irretrievably insolvent, processes to wind up including various forms of liquidation and receivership can be used (below).

Informal workouts

The term informal workout covers a range of private agreements between a company and one or multiple creditors. They are flexible and varied, with their only defining feature being the privacy of the agreement, with no involvement of outside parties such as courts. Workouts can include agreements that renegotiate, reduce, delay or waive pre-existing debts or terms of trade. The goal of such agreements is for the company to 'workout' of financial trouble and continue trading, with creditors benefiting from a continued stream of payments.

The benefits and disadvantages of workouts both stem from their informality. As private agreements they are flexible and importantly, do not always become public knowledge. This means that a company's reputation remains intact and is not affected by any of the stigma of entering administration, liquidation or receivership. However, as private transactions they are usually limited to the options available in dealing with a particular creditor or group of creditors, rather than creditors as a whole, and can lead to complications (such as voidable transactions or directors being liable for breach of

46 Technically, 'restructure' refers to an agreement between the company and its members (shareholders), not creditors. For the purposes of this report, the Commission uses the term more broadly, to include restructuring debt (and notes where instance relate solely to arrangements with members).

insolvent trading rules) should a liquidation end up occurring despite the efforts to renegotiate with creditors.

In Australia, informal workouts have become popular, particularly through the involvement of banks and other major financial institutions, as McGrathNicol noted:

> The clear trend in Australia since the early 1990s has been for all major banks and financial institutions to support and attempt to rehabilitate problem accounts for an extended period, often many years, before an insolvency appointment solution is implemented. Other than in cases of fraud, insolvency is considered the final and least attractive option by financiers and the last resort. (sub. 34, p. 3)

While the Commission appreciates the confidential nature of many workouts, to inform policy development it is seeking (de-identified) data relating to the frequency, and overall impact of informal workouts.

INFORMATION REQUEST

Is there available data relating to the frequency and importance (in terms of the overall value of debt) of informal workouts? If not, how should the Commission obtain this information — for example by a survey of banks or insolvency practitioners?

Where a large creditor is unwilling or unable to provide significant relief, or companies lack a good relationship with their creditors, more formal options may be required.

Schemes of Arrangement

Broadly, schemes of arrangement (‘schemes’) are an alternative available to companies seeking to restructure and avoid liquidation. They allow for the creation of a binding agreement between the company and its creditors that modifies the pre-existing legal rights of both parties and allows the company to continue trading.

Schemes are regulated under Part 5.1 of the Act. The Act does not restrict the nature of a scheme but typical features of schemes involve a partial curtailment of the creditors’ rights such as accepting less than the full amount owed, allowing for interest free periods, or payment by instalment over an extended period of time, or debt for equity swaps.

While the content of schemes is flexible, the process to establish them is not, requiring six formal steps:

1. *Proposal*: The proponent of the scheme, in concert with an insolvency practitioner, formulates a proposal. This reflects the contents of the scheme itself and generally contains information such as: alterations to the amount or timing of payment of debt, the duration of the scheme and powers of the scheme administrator and consequences of breaches by the company of the Scheme.

2. *Explanatory Statement*: Essentially an expansion on the proposal (and sent with it to the creditors), the explanatory statement describes the effect of the proposal on the company and its creditors. A Report as to Affairs (RATA — a summary of the company's financial position) must be attached to the Statement.
3. *Court Application*: At least 14 days after the proposal and explanatory statement are sent out to creditors, an applicant (the company, a creditor or shareholder, amongst others) can apply to the court for an order to convene a creditors' meeting.
4. *Creditors' meeting*: Following a court order of a meeting, creditors must be notified of the details of the meeting. The Scheme will be binding if a simple majority (50 per cent, by number) of the creditors at the meeting vote in favour of it, provided that the value of debts of those who voted in favour constitute at least 75 per cent of the total debts of creditors at the meeting.
5. *Court hearing*: If the creditors vote in favour of the proposed Scheme, another court hearing is required for the court to approve it. The court has a broad discretion to grant its approval 'subject to such alterations or conditions as it thinks just' (s411 (6)). This allows the court to verify, among other things that the Scheme (and process) complies with the Act, that the meeting was representative of creditors, would be accepted by the reasonable creditor, and is not contrary to the public interest (including schemes that have been designed to avoid tax liability). Further, the court cannot approve a scheme unless it is satisfied that the scheme has not been proposed to avoid takeovers requirements, and a written statement that ASIC has no objection to the scheme has been produced (s411(17)).
6. *Filing:* Finally, the court order approving the scheme must be filed with ASIC.

Despite the flexibility of content, this formality of process has led some to observe that schemes of arrangements are an unattractive option:

> … schemes have had limited appeal to debtors and creditors … [because] Court involvement is likely to render a scheme of arrangement slow and expensive … As a result, schemes of arrangement are now rarely used for an insolvent company. The [schemes] also allow solvent companies to be restructured [an arrangement with members, rather than creditors], and part 5.1 is more likely to be used in this context. (Duns 2002, p. 447)

Indeed, ASIC reports indicate that very few scheme administrators have been appointed in recent years: two in 2013-14, none in 2012-13 or 2011-12 and only five in 2010-11 (sub. 20, p. 45).

While they are rare, some participants in this inquiry noted that schemes have one advantage, that they are not seen as voluntary administration. They have been used more recently to:

> … facilitate large, complex corporate reconstructions of distressed enterprises including the Centro Group Alinta and Nine Entertainment … this has been, at least in part, to avoid the stigma and loss of value associated with the voluntary administration regime. (Arnold Bloch Leibler, sub. 23, p. 11)

Unlike Deeds of Company Arrangement, schemes can, in theory be entered into separately from other insolvency processes (specifically voluntary administration). However, in practice, a lack of a moratorium on creditor actions during a scheme creates a risk that individual creditors can undermine the attempts of the scheme to restructure the company, or use the threat of action to extract favourable concession (Arnold Bloch Liebler, sub. 23, pp. 11-12). As such moratoriums are available in voluntary administration, companies have some incentive to seek that protection. The relatively scarcity of schemes suggests this incentive dominates over any fear of the stigma of administration.

Voluntary Administration and Deeds of Company Arrangement

The main formal process for attempting to salvage a company is voluntary administration, which can lead to a deed of company arrangement (DOCA). Voluntary administrations are governed by Part 5.3A of the Act. Under s453A, the purpose of administrations are for the business and property of an insolvent company to be administered (by a third party) in such a way that either maximises the chance of the company (or part thereof) continuing to exist, or, if this is not possible, to result in a better return to creditors and members (shareholders) than would result from immediate winding up.

Voluntary administrations are initiated when an administrator is appointed. Although a liquidator or a secured creditor of (substantially) the whole of the company's assets can initiate an administration, more commonly the company itself initiates the process. The company may only appoint an administrator when the directors form the opinion that the company 'is insolvent, or is likely to become insolvent at some future time' (s436A).

Upon appointment, the administrator essentially controls the company (to the exclusion of management), with the power to carry on the business, and manage or dispose of any parts of the business or property (s437A). The administrator must also investigate the affairs of the company and report to the creditors with an opinion regarding the best outcome from the administration.

Administrations require two creditors' meetings. The first must be within eight business days of initiation and relates to the appointment of a committee of creditors and any decision to remove and replace the administrator (s436E). The purpose for the second meeting, held at the end of the administration, is for the creditors to decide the outcome of the administration (s439C). These include that the company is wound up (and a liquidation process begins), that the administration should end (and the company is returned to management), or that a DOCA is executed.

Deeds of Company Arrangement

One of the potential means of successfully restructuring a company and moving it away from insolvency, a DOCA is essentially an agreement between the company and creditors that follows from a voluntary administration. An administrator for the DOCA must be appointed and is typically, but not necessarily the former voluntary administrator. During the operation of a DOCA, the company continues to trade and, importantly for the directors, the company is not insolvent while under a DOCA.

The content of DOCAs is flexible, just as with informal workouts and schemes of arrangement (above) and can include agreement to waive or delay payment of debts, or a plan to pay in instalments. The DOCA deed itself must detail all these arrangements, as well as the circumstances under which it will terminate and the order of distribution of the company's property to DOCA creditors. The deed binds the company, its officers and members, as well as the deed Administrator. Creditors bound by the DOCA are unable to apply for a winding up order against the company in relation to debts that arose before the date specified in the DOCA.

Once the DOCA is executed and its administration begins, the Administrators will call in the funds payable. This may require the sale of assets or the injection of funds from directors or third parties. Creditors who can prove their debts are then paid. If they receive the dividend agreed under the DOCA, those payments are full and final satisfaction of their claims against the company — their existing claims are extinguished. Where the Administrator has paid all entitlements owed to all creditors under the DOCA, the deed is fully effectuated (that is, it has been fulfilled and all agreed payments and restructuring action have occurred) and the company may continue to trade free of those claims.

Where a DOCA is not fulfilled (or appears unlikely to be fulfilled), it can instead be terminated (meaning that the agreement reached is no longer binding). A DOCA can be terminated by court order, by resolution at a meeting of creditors, or in accordance with circumstances stipulated in the DOCA itself. Effectively, termination of a DOCA leads to liquidation for the company.

14.3 Winding up processes in Australia

Liquidation

Broadly, liquidation is the process of realising a company's assets and using the funds to pay off, as much as possible, the company's debts and liabilities.

ASIC reported that liquidations were by far the most common type of the nearly 14 000 appointments of an external administrator in 2013-14 — liquidators accounted for 71 per cent of appointments, receivers for over 16 per cent, voluntary administrators 9 per cent and deed administrators (for deeds of company arrangement) nearly 3 per cent (sub. 20, p. 45). The dominance of liquidations is in accordance with experience in other countries. For example, in England and Wales in 2006, liquidations accounted for 76 per cent of the total 17 285 insolvency procedures, administrations for nearly 21 per cent and receiverships for just over 3 per cent (Armour, Hsu and Walters 2008a).[47]

There are several forms of liquidation. A member's voluntary liquidation differs from the other forms in that it is only available when the company is solvent — that is, it is not in financial difficulty. According to ASIC administrative data, member's voluntary liquidations accounted for 22 per cent of the 96 244 liquidations undertaken since 1 January 2005. Creditors have no involvement in this process as they will be fully repaid. It is initiated by a special resolution (supported by 75 per cent of members) of the company. If the members vote in favour of winding up the company, a liquidator is appointed. If the liquidator discovers that the company is in fact insolvent, then the process is converted to either an administration or a different form of liquidation.

For the other forms of liquidation — a creditors' voluntary liquidation, or a court ordered provisional or official liquidation — the company must be insolvent (as defined under s95A of the Act).

Typically, liquidation is commenced by creditors who have proved the company to be insolvent after an application to the court under s459P of the Act. Both secured and unsecured creditors can apply. While in some cases proving insolvency, especially at a given moment in time, can be difficult, s459C stipulates several circumstances in which a company can be presumed to be insolvent. These include failing to comply with a s459E statutory demand (essentially a formal means for requiring that a debt be repaid within 21 days), execution of a judgment in favour of a creditor was returned at least partly unsatisfied or a receiver was appointed to enforce a circulating security interest ('a floating charge').

Liquidators are appointed by either the members or creditors of a company (in a voluntary winding up) or by the court when it orders that a liquidation commence. They are subject to many requirements (discussed below) but importantly they must be independent, and seen to be so.

As with an administrator, the liquidator takes over the operation of the company and can deal with its assets. The role of the liquidator is to effectively close the company. This requires an examination and realisation (typically by sale) of all the available assets of the company, equitable distribution of assets among creditors, and an examination of the events that led to the liquidation. This may reveal inappropriate ('voidable') transactions (which, unlike an administrator, the liquidator has some power to reverse to the benefit of the creditors),[48] and criminal offences, typically in relation to insolvent transactions or breaches of directors' duties (which must be reported to ASIC).

[47] The lower rate of receivership in the United Kingdom reflects reforms to the role of secured credit, discussed in chapter 15.

[48] Voidable transactions include insolvent transactions which encompass unfair preferences and uncommercial transactions (ss588FE (2) to (5)), unfair loans (s588 FE (6)) and unreasonable director-related transactions (s588FDA).

In discharging these functions, liquidators owe duties to the company, its creditors and members. The liquidator is also required to 'act honestly, fairly and impartially at all time, and must avoid any conflicts of interest (mondaq 2009a).

Following investigation by the liquidator, the liquidation is most commonly finalised by distributing the available funds to creditors and deregistering the company. Alternatively, the liquidator can commence a voluntary administration if they believe there is some prospect of salvaging the company (in effect, that a company is at the stage where it is likely to be insolvent but is not yet insolvent). A final option is for the court to order the termination of the liquidation because a solvent company was incorrectly allowed to enter liquidation.

Receivership

Receivership is a form of administration tied to the conditions of a contract for secured credit. A receiver is appointed to take control of property (the security), and acts as an agent of the party entitled to the property, that is the secured creditor (although the appointing instrument can state that a receiver is also to act as an agent of the company). The main duty of a receiver is to realise or profitably manage the asset in order to pay the secured creditor. Receivership differs from other forms of administration in that, although it is most commonly applied to companies, it can also apply to sole traders (and other individuals) or partnerships.

Receivers are typically appointed privately, in accordance with the authority provided by the contract for security upon the occurrence of some failure to pay a debt. Rarely, a court may appoint a receiver in circumstances where the instrument of appointment (the security contract) is somehow flawed. Courts have been reluctant to do so, unless it is a matter of equity (in the legal sense) and another, more appropriate, equitable remedy is not available (mondaq 2009b).

The role and powers of a receiver are dependent on their instrument of appointment and are typically tied to the secured property itself. This could be a core component of a business (such as the business's premise or the owner's house) or a useful but nonessential asset that the business could survive without. As such, the role of a receiver, and the impact on the company, can vary widely. The powers include matters tied directly to the asset — such as the ability to control, protect, lease or sell the property — and in some instances where the security is over (substantially) the whole of the company, may include wider powers to carry on the business of the company, including hiring or discharging employees.

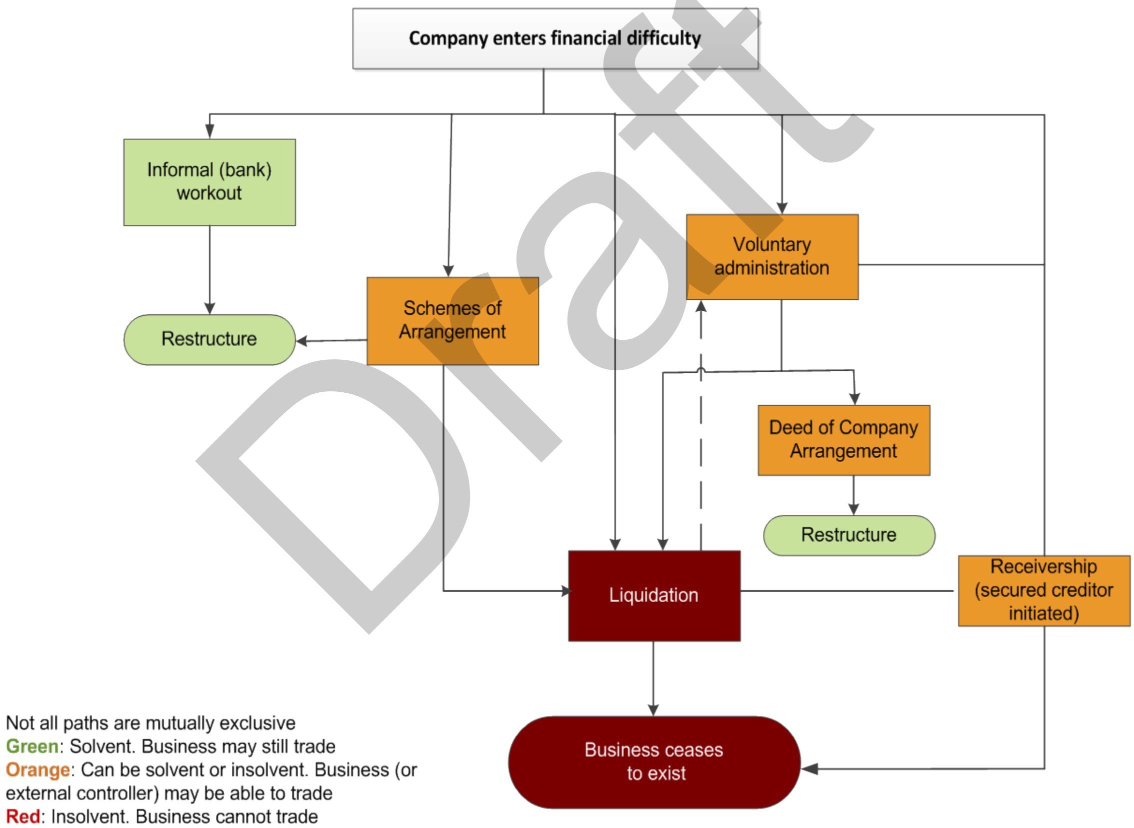
Given their private nature and connection to a particular asset, receiverships can occur concurrently with the other forms of administration — voluntary administrations, DOCAs and liquidations. In such circumstances, the extent of the asset 'carved out' by a receivership will affect the possibility of restructure or the ability of a liquidator to distribute funds to the wider group of creditors.

14.4 Scope for reform of insolvency processes

Considering the process as a whole

The sections above described each limb of the broad insolvency process (including both restructuring and winding up). In order to examine the effectiveness of the system it is important to understand how each of these elements interact with each other. Figure 14.1 presents a simplified summary of the processes that may be available to a business entering financial difficulty.

Figure 14.1 **The restructuring and insolvency framework in Australia**



Areas for potential reform

While the system has generally been regarded as sound, there have been many recent calls for review of Australia's insolvency laws:

> The committee recommends that the government commission a review of Australia's corporate insolvency laws to consider amendments intended to encourage and facilitate corporate turnarounds. The review should consider features of the chapter 11 regime in place in the

> United States of America that could be adopted in Australia. (Senate Economics References Committee 2014, p. xxxiv)

It is the Commission's intention that this inquiry address the policy needs identified by the Senate Committee. In addressing the need for reform the Commission has sought to answer three key questions.

Does the system promote effective restructuring?

ASIC administrative data made available to the Commission indicates that current arrangements do not promote effective restructuring. Failure rates after a company enters voluntary administration are high:

- 37 per cent are deregistered within two years of the commencement of a voluntary administration
- 57 per cent are deregistered within three years
- 70 per cent are deregistered within four years
- 78 per cent are deregistered within five years.[49]

Similarly, research conducted for ARITA suggests that 'in 72 per cent of cases a deed of company arrangement delivers a quasi-liquidation outcome. However for 28 per cent of deeds a successful restructuring appeared to be the outcome' (sub. 31, p. 38).[50] This accords with feedback from participants regarding a 'lack of a restructuring culture' (ARITA, sub. 31, p. 1) in Australia and a perception that the insolvency regime in general is seen as 'punishing and stigmatising corporate failure' (Arnold Bloch Leibler, sub. 23, p. 4).

Given the general perception of the formal restructuring system, it is hardly surprising that informal workouts are becoming more common. While the Commission appreciates the increased use of informal workouts has kept companies out of the insolvency system, it nonetheless considers that such workouts may be functioning as a replacement, not supplement for the existing system — suggesting a desire to avoid the formal system. The renegotiation of contracts in efforts to sustain a company and safeguard a stream of payments is laudable on the part of creditors, but it also has drawbacks. These include a

49 Includes both companies under administration and companies operating under a DOCA. Percentages are calculated as a proportion of all companies who go through a voluntary administration process and that are currently registered or deregistered. Does not include companies still in external administration as of 26 February 2015. The Commission has conducted a preliminary analysis of this data for the purposes of the findings reported in this chapter, and intends to further explore the data for the inquiry's final report.

50 Care needs to be taken in interpreting such figures given the potential for sample bias — that is, only those companies in some type of financial difficulty are likely to enter administration or a DOCA, so are likely to be more prone to eventual failure than the broader stock of companies. Further, this figure is not out of step compared to estimates of the success of the United States Chapter 11 process, discussed below.

potentially limited number of 'levers' available to those attempting to reorganise the company as a whole (and, conversely, the exhaustion of one lever by the time a company reaches administration), as well as the possibility that deals could fall through, or in fact be later (rightly) undone by liquidators.

Are assets redeployed efficiently in the event of failure?

In terms of unlocking capital that could potentially be applied to productive uses, the time taken for the completion of a company cessation (including liquidation and deregistration) is of concern. ASIC administrative data on appointment of external administrators suggests that, for all types of insolvency process, the median time from the first appointment of an external administrator to deregistration is 513 days, or 1.4 years. Although the Commission appreciates the systemic importance of investigating causes for failure and any possible criminal actions, substantial delays for such investigation are likely to be disproportionate where relatively few assets are at stake.

Does the system appropriately balance the interests of all affected parties?

The question of balance is twofold. First, there is the matter of balance between creditors and debtors. As identified above, the Australian system is generally regarded as too creditor focused. While the insolvency system supports the financial system and the availability of credit by prioritising creditors' rights and returns, it sometimes does so at the expense of genuine restructuring, or as an impediment to expedient liquidation. The Commission has considered such questions in the context of restructuring and winding up, and achieving the balance within those processes.

Second, there is balance with respect to the rights of particular creditors. Specifically, there is a question of how the role of receivers in enforcing or protecting secured creditors' rights can undermine the 'group' insolvency process (intended to prevent a 'race to court') and diminish the possibility of a restructure or sale as a going concern.

Should Australia adopt the United States chapter 11 system?

A common comparison made of Australia's insolvency regime is with the United States' 'chapter 11' process for reorganisation (the features of this process are briefly described in box 14.3). For example, the Senate Economics References Committee 2014 report into the performance of ASIC (cited above), and the Financial Systems Inquiry (The Treasury 2014d, p. 266) each considered adoption of the chapter 11 process.

Box 14.3 **Chapter 11 of the United States Bankruptcy Code**

Chapter 11 of the United States Bankruptcy Code allows the reorganisation of debt by companies (and can also be used for partnerships and individuals). A chapter 11 case commences when a company (or one of its creditors) files a petition in the Bankruptcy Court.

Unlike the use of independent voluntary administrators, a company that enters chapter 11 becomes a ‘debtor in possession’ and retains control of its own affairs, albeit now owing a fiduciary duty to the creditors (whose views are represented by a committee), and operating under the supervision of the Bankruptcy Court.

The Bankruptcy Court is heavily involved in the chapter 11 process. The Court can replace the board of the debtor with a trustee in cases of misconduct, must approve any actions by the debtor outside of the normal course of business, and adjudicates challenges from creditors. Further, proposed reorganisation plans emerging from the chapter 11 cannot proceed without the approval of the Court.

Initiating a chapter 11 process immediately freezes all creditors’ rights as at the date of initiation — for example, debts cannot be collected and security property cannot be sold while the chapter 11 process is on foot. This ‘automatic stay’ also prohibits, subject to some exceptions, the enforcement of ipso facto clauses in contracts.

A chapter 11 process is typically concluded when the debtor’s ‘reorganisation plan’ is confirmed (though the process can be converted to a liquidation, or the plan itself can be a form of liquidation). Plans are confirmed by a vote of the creditors, divided into classes of claim. If the vote is unsuccessful, the debtor can apply to the Court under the ‘cramdown’ sections of the Code to have the plan approved, provided at least one class of impaired creditors approved and the Court finds the plan to be ‘fair and equitable’ to any objecting class.

Source: United States Courts (nd) and CAMAC (2004b)

The ‘debtor in possession’ model

While chapter 11’s high level focus on allowing a business to continue seems appealing, past reviews have identified that it would not be appropriate for Australia to adopt either the chapter 11 system as a whole, or its core feature: the role of debtor in possession. For example, in 2004, the Corporations and Markets Advisory Committee (CAMAC) found that:

> There is no clear case for introducing a debtor in possession regime based on Chapter 11 of the United States Bankruptcy Code, either as a substitute for voluntary administration or as an additional procedure. …
>
> Chapter 11 depends on extensive judicial supervision to protect creditors, including a requirement of court approval for any action by the company in Chapter 11 outside the ordinary course of its business. Australian Courts are reluctant to become involved in commercial decision making, which requires non-judicial skills and knowledge … Also, the judicial infrastructure required for the operation of a Chapter 11 type regime in Australia is currently not available. (CAMAC 2004b, p. 17)

Similarly, a Parliamentary Joint Committee on Corporations and Financial Services in 2004 concluded that:

> Most submissions that commented on the US Chapter 11 model argued strongly against its adoption. Two of the major concerns expressed about a Chapter 11 regime were — the company remaining in the hands of the debtor and the length of the process.
>
> The Committee is not persuaded to the view that an insolvency procedure modelled on Chapter 11 of the US Bankruptcy Code is appropriate for the Australian corporate sector. Nor does it consider that wholesale amendments to the voluntary administration procedure to conform to Chapter 11 would have the potential to make a significant improvement in outcomes … (Parliamentary Joint Committee on Corporations and Financial Services 2004, p. xxi)

Allowing the very people responsible for entering financial difficulty to manage its rehabilitation (as distinct from the control resting in external administrators in the Australian system) is also seen as a potential failing of the chapter 11 process, as Harmer noted:

> The debtor in possession approach requires, ultimately, the engagement of professional advisers by the debtor. That is simple fact. Very few, if any, successful cases of Chapter 11 have been done 'in house'. (Harmer 2004, p. 1)

The necessity of such outside advice suggests that the maintenance of control in the company is, at least in part, illusory.

The success of restructuring under Chapter 11

A further concern is the degree of 'success' of a firm entering chapter 11 — that is, what percentage of firms continue. While there are a number of estimates for this, the available data (Eckbo 2008) indicates that, between 1990 and 2003, the average rate of confirmation of a reorganising plan was 29 per cent. To complicate matters, 'confirmation' includes plans that lead to liquidation. Of the publicly reported results of plans confirmed between 1979 and 2002, Hotchkiss and Mooradian (2004) reported that liquidation results from a chapter 11 process in 27 per cent of the examined cases, or are merged with another company in 8 per cent of cases (with the remainder of cases surviving as a public or private company) — implying that the true 'success' rate is under 20 per cent. Evidence submitted at the time of the CAMAC inquiry was more pessimistic, and indicated that only about 6.5 per cent of debtors who enter chapter 11 were successfully rehabilitated in the long term, and that the stay of proceedings initiated under a chapter 11 filing has been used to avoid liability under contracts with employees and to lessen the impact of large tort liabilities (AICD 2003, pp. 1–2).

The cost and complexity of chapter 11

Chapter 11 is also not regarded as perfect in the United States. There are calls to reform the chapter 11 process, first enacted over 25 years ago, as a recent major review found that it was not suitable for the complexity of modern large companies and too expensive for small ones:

> … today's financial markets, credit and derivative products, and corporate structures are very different than those existing in 1978 when Congress enacted the Bankruptcy Code. Companies' capital structures are more complex and rely more heavily on leverage, … their asset values are driven less by hard assets (e.g., real estate and machinery) and more by services, contracts, intellectual property, and other intangible assets; and both their internal business structures (e.g., their affiliates and partners) and external business models are increasingly multinational. In addition, claims trading and derivative products have changed the composition of creditor classes. … the Bankruptcy Code was not originally designed to rehabilitate companies efficaciously in this complex environment.
>
> Moreover, anecdotal evidence suggests that chapter 11 has become too expensive (particularly for small and medium-sized enterprises) … Some professionals suggest that more companies are liquidating or simply closing their doors without trying to rehabilitate under the federal bankruptcy laws. Commentators and professionals also suggest that companies are waiting too long to invoke the federal bankruptcy laws, which limits companies' restructuring alternatives and may lead to premature sales or liquidations. (American Bankruptcy Institute 2014, p. 12)

Chapter 11 is unsuited to the Australian framework

Where they did comment on it, participants in this inquiry were generally of the view that wholesale change was not necessary:

> The insolvency regime in Australia is generally sound and effective with a robust legal framework (both legislative and Court). Whether by design or accident, and contrary to media and public perception, almost all businesses already get an extended opportunity to succeed before an insolvency appointment occurs.
>
> Notwithstanding, targeted improvements to the regime are warranted and would be well received, by the profession and the community. (McGrathNicol, sub. 34, p. 5)

Even those — such as the Australian Chamber of Commerce and Industry (ACCI, sub. 11) and AICD (sub. 3) who favoured a move away from a focus on creditors and adopting 'elements' of the chapter 11 system do not advocate adoption of a debtor in possession model but rather the use of 'safe harbour' provisions and a moratorium on ipso facto clauses (chapter 15).

In the Commission's view, increasing the role of the courts in oversighting what is essentially an administration is unlikely to improve its speed, or cost-effectiveness — two factors that are key to a successful restructuring. As noted above, the Australian system performs relatively well, and the United States system is not perfect. As such, the degree of change involved — an increase to the role of courts and the accompanying court infrastructure, the insolvency process, the role of creditors and debtors — is disproportionate to any potential gains from wholesale adoption of the chapter 11 system or the debtor in possession model.

DRAFT FINDING 14.1

While some specific reforms are warranted, wholesale change to the Australian insolvency system is not justified.

In particular, several factors — including the costs of the process, the role of courts and changes to the roles of creditors and debtors — indicate that the overall costs are disproportionate to any likely gains from a wholesale adoption of chapter 11 of the United States Bankruptcy Code.

The timing of restructure is a particular concern

The barriers to effective restructuring arise from a confluence of interlinked factors in the Australian system and commercial environment. Together, the effects various aspects of Australia's insolvency system contribute to a regime that the Chief Justice of Western Australia (Martin CJ), described as one:

> … which arguably encourages insolvent administration, and discourages financial restructuring and trading out of difficulty.
>
> There are a number of aspects of our regulatory regime which arguably encourage resort to insolvent administration, even in cases in which there is a real prospect that a financial restructure and altered business plan might save the entity involved, to the benefit of its creditors and proprietors.(Martin 2009a, p. 13)

Martin CJ went on to note the impact that continuous disclosure requirements can have (2009a, p. 15). In short, at a time when a listed company may be working on an informal workout with a major creditor, a requirement to publicly and completely inform the market may undermine sensitive deals and thwart attempts at restructure, resulting in insolvency.

Martin CJ also focused on the impact of the insolvent trading laws on directors' liabilities under s588G of the Act, noting that they were 'arguably the strictest in the world', and had particular effect on the incentives faced by non-executive directors (2009a, pp. 14, 16).

Several participants in this inquiry — such as the AICD (sub. 3), ARITA (sub. 31) and the Law Council of Australia (sub. 14) — also highlighted the effect of the insolvent trading laws. For example, ACCI explained that:

> The threat of liability for insolvent trading leads directors of larger businesses to seek protection of the voluntary administration regime too readily rather than seeking a restructure of the business. This is primarily due to s588G of the *Corporations Act 2001*, which exposes directors to potential civil liability, if they incur any further debt, if the business entity is insolvent at the time of incurring debt or becomes insolvent as consequence of incurring the debt. … As a consequence, directors of large business entities readily seek the provisions of the insolvency regime when the entity may, in fact, only be experiencing temporary financial difficulties. (sub. 11, p. 16)

Commentators, including judges and academics have also noted the impact of the insolvent trading regime:

> The Australian insolvent trading provision encourages directors to put businesses to the sword even where there may be prospects for future prosperity. An effective culture of corporate rescue requires a number of key elements, including co-operation of major stakeholders. Directors can rightly feel hesitant about participating in a rescue attempt that could expose them to personal liability. … The threat of personal liability sends the wrong message, at the wrong time. It is important that struggling businesses are not put to a premature death because of an unwillingness of company directors to expose themselves to personal liability. (Harris 2009, p. 15)

These incentives have contributed to a culture of risk aversion amongst directors of large companies — that is, those for whom the threat of personal liability outweighs any potential benefits from attempting to continue the business.

Conversely, those directors who have a personal stake in the company (typically of smaller companies) face a different set of incentives:

> … small companies most often have directors who are also owners and guarantors of the company's liabilities, and they do not necessarily have the same 'professional' reputation to preserve. Theirs is more a business and commercial focus. Accordingly, in the 'insolvency twilight zone', they have everything on the line and tend to be comparably large risk takers. The threat of personal liability for insolvent trading and of breach of directors' duties is perceived to be far less. (ARITA, sub. 31, p. 16)

For these directors, they may continue to trade for too long, as the option of putting the company under external control (in voluntary administration) is seen as unpalatable. In continuing to trade they may incur further debts and exhaust possibilities for restructure. These actions can result in there being little opportunity for any voluntary administrator to restructure the company, or in more extreme cases drain the company of assets available to distribute to creditors in an eventual liquidation.

A further concern raised with the Commission was the perception of voluntary administration in Australia not as an opportunity to restructure, but rather as an admission of failure that carries with it a 'stigma' (ARITA, sub., 31, p. 1).

Together, these factors contribute to an overall lack of a restructuring culture in the Australian corporate world.

DRAFT FINDING 14.2

The current culture, incentives and legal framework around voluntary administration inhibit its effectiveness as a genuine restructuring mechanism.

Is there a need for fundamental reform?

The Commission has identified that there are clear areas for improvement in Australia's insolvency system, this is not to say that the system is fundamentally broken — there are examples of successful restructures, assets are redistributed and transactions investigated. Indeed, on some bases — cents in the dollar recovered, cost as a percentage of the estate (the company's assets at the time of insolvency) and creditor participation as assessed by the World Bank — the Australian system compares favourably to systems in countries such as the United Kingdom and the United States (table 14.1).

Table 14.1 **Comparison of insolvency regimes[a]**
2014

	Overall 'Resolving Insolvency' rank	*Cost (% of estate)*	*Recovery rate (cents in the dollar – secured debt)*	*Reorganisation proceedings index (0-3)*	*Creditor participation index (0-4)*	*Strength of insolvency framework index (0-16)*
Australia	14	8.0	81.9	0.5	3	12
Canada	6	7.0	87.3	2	3	13.5
New Zealand	28	3.5	83.6	0.5	2	8.5
United Kingdom	13	6	88.6	1	2	11
United States	4	8.2	80.4	3	3	15

[a] Selected economies and metrics drawn from the World Bank's 'Resolving insolvency' survey, a subset of the 'Doing Business' project to compare business regulation across 189 economies.

Source: World Bank Group (2015a)

While the Commission has determined that wholesale adoption of a framework akin to chapter 11 is not warranted, it may be possible to 'cherry pick' certain components of the chapter 11 system to achieve the desired reform outcomes. As noted by an Australian restructuring lawyer working in New York:

> We do not need to replace Part 5.3A [voluntary administration] with Chapter 11 (for a start, corporate Australia could not afford it). Chapter 11 is just one spoke in the U.S. corporate wheel and Australia has a fundamentally different approach to corporate governance … [instead] We should amend Part 5.3A to include one of Chapter 11's 'first stage' value preserving features [ipso facto clauses] and our insolvent trading laws to allow Part 5.3A to better facilitate genuine operational and balance sheet restructuring at the SME level. (Cheetham 2014, p. 26)

However, perceived failings with the Australian system do not imply that companies should be 'saved' at all costs — in some cases an expedient liquidation would likely be the best overall outcome from a company entering financial difficulty. Instead, the problems with the current system point to two main areas for reform. First, the timing and effectiveness of restructuring processes needs to be considered to ensure that genuine attempts at reorganisation are not unduly hindered. Second, where liquidation is required, the processes for doing so achieve an appropriate balance between expedience and orderly investigation. Reforms to facilitate this are considered in chapter 15.

15 Corporate insolvency: reforms

Key points

- The Commission has identified a range of reforms aimed at two main aspects of Australia's insolvency system: improving the effectiveness of restructuring options and ensuring that winding up is as expedient as possible.
- In a complex area of law such as insolvency, it is important that any changes do not introduce opportunities for 'gaming' the system.
- To improve genuine opportunities for corporate restructure:
  - the timing of voluntary administration should be earlier, and voluntary administration should not be available to companies that are already insolvent
  - there should be provision for a limited safe harbour period prior to voluntary administration for directors to obtain independent restructuring advice without liability for insolvent trading
  - ipso facto clauses that allow termination of contracts solely due to insolvency events should be prevented from operating until a liquidator has been appointed.
- In order to ensure that winding up processes are as expedient as possible, and remain effective in detecting wrong doing:
  - a streamlined 'small liquidation' process should be created to minimise regulatory burdens in instances where few assets are at stake
  - the Fair Entitlements Guarantee scheme to provide for employee entitlements should continue, with amendments to cap redundancy payouts and improve the Government's ability to recover its liabilities as a creditor
  - company directors should be required to obtain a Director Identity Number to assist in enforcement activities, including those designed to detect and prevent 'phoenix' activity
  - changes should be made to the role and power of receivers such that secured creditors' rights are still preserved, but that this is done so without undermining orderly group restructuring and insolvency processes.

As identified in chapter 14, the Commission considers there is scope for reform to specific aspects of Australia's insolvency system. The reforms are twofold. The first element focusses on the scope for a genuine opportunity to restructure a company that has just entered, or is about to enter, financial difficulty. The second element focusses on the efficient operation of the winding up process, with reforms aimed at providing an orderly but expedient process.

As is the case with the insolvency process itself, elements of these reforms can interact and overlap with each other. As such, the Commission has considered its proposals as they affect the overall insolvency framework.

15.1 The timing of restructure

There are two principal factors affecting the timing — relative to the company's financial condition — of entering formal restructuring (in particular, voluntary administration). These are when voluntary administration becomes legally available and the incentives to either rush to, or avoid, administration.

Improving the timing of voluntary administration

As discussed in chapter 14, a company may only appoint an administrator when the directors form the opinion that the company 'is insolvent, or is likely to become insolvent at some future time'. Despite the intention of voluntary administration (being primarily to maximise the chance of the company continuing to exist in some form), that it is available when a company is already unable to pay a debt causes both real and perceived issues. A commercial law firm with significant insolvency experience noted the impact of this perception, or 'stigma':

> … the stigma associated with an appointment and aspects of the current statutory regime will often immediately harm the goodwill and value of the enterprise … the stigma arises because the voluntary administration regime is only capable of being used as a restructuring tool in circumstances in which the board has formed the view that the company is, or is about to become, insolvent. The resulting delay in commencing the voluntary administration process undermines the prospects of a successful reconstruction of the company. Consequently, voluntary administration is too often used as a de-facto liquidation procedure, or as a prelude to liquidation. (Arnold Bloch Leibler, sub. 23, p. 4)

Such a perception can have a real impact on the value of the company as suppliers and customers may abandon the company once administration is declared — particularly where they have a contractual right to do so through 'ipso facto' clauses (discussed below).

Further, that voluntary administration can occur during (not only before) insolvency can mean that a company has exhausted its funds. In these cases, the options available to an administrator to attempt to restructure a company may be severely limited, as reflected in the low survival rates of companies that have been through voluntary administration (chapter 14).

To remedy this, Arnold Bloch Leibler advocated that section 436A of the *Corporations Act 2001*(Cth) ('the Act'):

> … be amended so that it is available to a company whose board forms the view that the company may become insolvent at some future time or expressed differently is in the "twilight of solvency"

> but not insolvent (rather than necessarily being insolvent at that time, or imminently about to become insolvent). (sub. 23, p. 7)

The Commission considers that creating a distinction between restructuring and winding up options should provide both directors contemplating restructuring and creditors (including suppliers) responding to it with a clearer signal of the intent of the process. Such a change may also require amendment to the objectives of voluntary administration (s435A of the Act) such that it is intended for the reorganisation of companies approaching, but not in, insolvency.

Creating a clear delineation between a restructuring process and liquidation may address a significant degree of the current negative perceptions about restructuring. However, it may also be necessary to distinguish between the 'old' voluntary administration process and any new 'independent restructuring' process in order to effectively nullify the existing stigma around the process. Such a 'rebranding' was also advocated by Arnold Bloch Leibler (sub. 23, p. 6). While some may regard this as a largely cosmetic exercise, at this stage, the Commission considers that it has merit as a relatively costless means of improving the potential for effective restructuring.

The Commission is mindful that introducing such a clear delineation may be difficult in practice. As noted in chapter 14, judging the precise moment of insolvency can be difficult and imprecise. However, the Commission considers that a clearer delineation between restructuring and winding up processes should reduce the incidence of irretrievably insolvent companies entering voluntary administration. In particular, the Commission considers that administrators should be under a duty to convert a restructuring into a liquidation where the company is insolvent (and there is no immediate prospect of exiting insolvency). Conversely, liquidators presently have the ability to convert a liquidation into a voluntary administration if they believe there is some prospect of salvaging the company. This should continue to be the case, with liquidators capable of converting a process into an independent restructuring.

DRAFT RECOMMENDATION 15.1

Section 436A of the *Corporations Act 2001* (Cth) should be amended such that a company may only appoint an administrator (and commence an 'independent restructuring' process) when the directors form the opinion that the company may become insolvent at some future time, but is not currently insolvent.

- The option to appoint an administrator to restructure when the company is insolvent should be removed.
- If an administrator determines the company is insolvent, liquidation should be commenced.

The Commission appreciates that such reforms are not without potential pitfalls. In particular, McGrathNicol (an advisory firm with substantial insolvency and restructuring experience) noted that there was a 'natural tension' between:

i. facilitating the early appointment of insolvency administrators, when there are assets and goodwill remaining within the business which present options for successful restructuring and/or facilitating an improved return to creditors; and

ii. giving management as much time as possible to engineer the turnaround of the business such that unless they succeed, by the time an appointment occurs the business has been drained of liquidity and goodwill such that there is minimal asset value left to satisfy creditors and little hope of a successful restructuring occurring such that the business can return to solvent trading. (sub. 34, p. 3)

The Commission considers that the solution to this tension does not lie in 'picking' a regulatory system that inherently favours either 'early' voluntary administration or allowing management opportunities to turnaround the company (such as the 'debtor in possession' model in the United States does). Instead, the regulatory system should provide viable options for company directors to make an informed, free of any distorted incentives and undue barriers to the effectiveness of each option. A proposed 'safe harbour' to allow directors to receive advice but retain control is one such option.

A safe harbour for directors?

As identified above, the threat of Australia's insolvent trading laws, combined with uncertainty over the precise moment of insolvency has long been identified as a driver behind companies entering voluntary administration, sometimes prematurely. The AICD expanded on the impacts that insolvent trading laws had on the decisions facing directors, arguing that the law:

- … not only encourages, but effectively mandates directors to move to external administration as soon as a company encounters financial difficulties in order to avoid personal liability and consequent reputational damage;
- discourages directors from taking sensible risks when considering other kinds of informal corporate reconstructions or 'work-outs' to deal with a company's financial problems;
- provides an incentive for creditors, especially secured creditors, to act in their own self-interest and arrange for the disposal of key assets and the termination of continuing contractual arrangements as soon as possible;
- can lead to financially viable companies suffering the consequences of external administration, including ceasing to be a 'going concern', suffering the loss of value and goodwill and incurring the expense of engaging administrators or receivers when it may have been possible under a less prescriptive legislative regime for the company to restructure itself and secure its financial standing; (sub. 3, p. 3)

In response to these impacts, the AICD advocate the 'Honest and Reasonable Director Defence', involving legislative amendment to the effect that:

> Notwithstanding any other provision of this Act or the ASIC Act, if a director acts (or does not act) and does so honestly, for a proper purpose and with the degree of care and diligence that the director rationally believes to be reasonable in all the circumstances, then the director will not be liable under or in connection with any provision (including any strict liability offence) of the Corporations Act or the ASIC Act (or any equivalent grounds of liability in common law or in equity) applying to the director in his or her capacity as a director. (sub. 3, p. 5)

However, it is important to note that this is a circumstance where the spectre of action looms larger than the actual (likely) consequence. The rate of successful enforcement of insolvent trading actions is low — there were only 103 insolvent trading cases between the law's introduction in 1961 and 2004. While the court ordered that compensation be paid in three quarters of those cases, more serious sanctions were extremely rare: only 15 per cent of cases involved criminal proceedings and only two cases involved an order banning directors from managing companies (James, Ramsay and Siva 2004). This is in part due to the difficulty to prove an individual's intention, state of mind and personal knowledge, particularly in relation to complex financial matters. Further, pursuing such cases can be expensive for regulators as the presence of reasonableness tests (ss588G(1)(c) and (2)(b)) means there is considerable scope to mount a defence based on the circumstances. Accordingly, the Commission considers that the legislation already contemplates an appropriate balance between reasonable actions, defences (under s588H) and possible enforcement in cases of genuine wrongdoing.

Nonetheless, for legally aware directors of typically larger companies, insolvent trading laws carry a risk of liability and therefore have a real effect. As ARITA noted:

> Historically insolvent trading actions are difficult to prove and expensive to pursue. The reality that there are limited or no assets in a large number of administrations means that insolvent trading claims are unlikely to eventuate, particularly in SMEs where the claims are likely to be at the smaller end. Furthermore, asset protection strategies employed by directors and the fact that secured creditors and a number of trade creditors will hold personal guarantees from directors, means that often directors are unable to meet any compensation orders if an insolvent trading action is proved against them. … [however] the threat of an insolvent trading action can result in out of court settlements in liquidations and payments under deeds of company arrangement to prevent further action being taken, resulting in benefits for the creditors. (ARITA 2014a, p. 12)

As such, there is a disincentive for directors to take what could otherwise be appropriate risks This is particularly tied to the difficulty in judging the precise moment of insolvency. Rather than creating blanket defences, the Commission therefore considers that a solution targeted at addressing issues of timing, as well as the concerns raised by the AICD, is more appropriate.

Providing for a 'safe harbour', as advocated by ARITA (sub. 31) and the Law Council of Australia (sub. 36, attachment 1), would address the issue of the timing of insolvency directly (box 15.1). Such a model allows directors the opportunity to undertake a rational decision making process free from fear of liability, without fundamentally altering the balance within the law and still protecting the company and creditors from reckless action when a company is already in debt. Several other participants, including the Chamber of

Commerce and Industry Queensland (sub. 8), ACCI (sub. 11) and Arnold Bloch Leibler (sub. 23) also supported the concept of a safe harbour.

Not all participants were enthusiastic. McGrathNicol noted the theoretical benefits of safe harbour and 'do not oppose' it, but 'were sceptical as to its impact'. Specifically, they argued that smaller operators held no fear of insolvent trading and would therefore have no incentive to enter a safe harbour, preferring to carry on trading as long as they can. They also submitted that 'it has not been our experience that boards inappropriately seek to enter formal insolvency to avoid personal liability'. Finally, they argued that addressing the issue of 'ipso facto' clauses would obviate the need for safe harbour (sub. 34, p. 4).

The Commission agrees that directors of smaller companies face different incentives, but notes that providing a restructuring option that allows them to retain control of the company while receiving formal advice should at least be more appealing than surrendering control (of what are often tightly held companies) to an external administrator. Finally, as discussed below, the Commission agrees that addressing ipso facto clauses is important, but remains of the view that providing a number of options that facilitate restructuring is likely to maximise outcomes for all stakeholders.

Box 15.1 ARITA's safe harbour — the 'business judgment' rule

ARITA advocated a 'business judgment' rule, which requires that directors:

- make a business judgment in good faith for proper purpose
- after informing themselves about the subject matter of the judgment to the extent they reasonably believe to be appropriate
- rationally believe that the judgment was in the best interests of the corporation
- the director has taken all proper steps to ensure that the financial information of the company necessary for the provision of restructuring advice is accurate, or is ensuring that all resources necessary in the circumstances to remedy any material deficiencies in that information are being diligently deployed
- the director was informed with restructuring advice from an appropriately experienced and qualified professional engaged or employed by the company, with access to all pertinent financial information, as to the feasibility of and means for ensuring that the company remains solvent, or that it is returned to a state of solvency within a reasonable period of time
- it was the director's business judgment that the interests of the company's body of creditors as a whole, as well as members, were best served by pursuing restructuring, and
- the director took all reasonable steps to ensure that the company diligently pursued the restructuring. (2014a, pp. 12–13)

ARITA also stressed that safe harbour should not be seen as relaxing directors' responsibilities:

> If anything, their responsibilities should be seen as being heightened during this period by the business judgment rule requiring positive and beneficial governance thresholds to be met before the rule can be used.
>
> Consideration should also be given as to whether, in situations where the safe harbour protections are not met, the insolvent trading rules should actually be easier for a liquidator to prove in order to be able to obtain compensation for the affected creditors. (2014a, p. 13)

In order to preserve the independence of practitioners and prevent any conflicts of interest arising, advisers used during the safe harbour period should be disqualified from appointment in any subsequent formal insolvency process, and their involvement advised to ASIC. As Chief Justice Martin noted in relation to the current system, in addition to genuine conflicts, perceived conflicts can also affect the willingness of creditors to cooperate with insolvency processes:

> Sometimes those who have given advice to the directors in respect of possible insolvency administration will be appointed as administrators or legal advisors to the administrators. Creditors and investors will not uncommonly be suspicious about the motives of those who have provided advice in a context in which their own personal interests in the revenue to be derived from insolvency administration might be seen to be in conflict with the interests of investors and creditors, whose interests may be best served by a financial restructure. (2009b, p. 17)

As with voluntary administration, the Commission intends that safe harbour should provide a genuine opportunity to restructure. However, restructuring should not be endless and should not be used to indefinitely and repeatedly extend the life of a company that according to sound financial metrics should be 'dead' — the Commission does not intend to create a horde of 'zombie companies'. Instead, where the independent adviser sees that insolvency has occurred (or is about to), they should be under a duty to inform both directors and creditors of this, so that a liquidation process can be initiated. From this point, the safe harbour protections would cease and should directors incur any debts after this time they would expose themselves to potential liability.

Further, safe harbour should not be seen as a 'free pass' for directors to wash their hands of any liability. Instead, it should be used only as an opportunity to pause when financial difficulty appears imminent and seek external advice to ensure that directors are informed of the options for continuing the company's existence.

DRAFT RECOMMENDATION 15.2

The *Corporations Act 2001* (Cth) should be amended to include provision for a 'safe harbour' to allow companies and their directors to explore restructuring options without liability for insolvent trading. During such a period, the directors would retain control of the company, but receive independent advice from registered advisers.

- Advisers appointed in safe harbour would be disqualified to act as administrators, receivers or liquidators in any subsequent insolvency process for the company.
- The company would be required to inform the Australian Securities and Investments Commission, and the ASX in the case of listed companies, of the appointment of an adviser.
- In informing themselves and the adviser, and determining whether to act on any restructuring advice, directors would be under a duty to exercise their business judgment in the best interests of the company's creditors as a whole, as well as the company's members.
- If the positive thresholds above are met (and evidenced), a director's duty not to trade while insolvent would be considered to be satisfied during the period of advice and for actions directly related to implementing the restructuring advice.

INFORMATION REQUEST

The Commission seeks participants views on further aspects of the design of a 'safe harbour' for directors, particularly:

- *When should safe harbour be available, and not available, especially in relation to the changes to voluntary administration suggested in draft recommendation 15.2?*
- *What protections should be included to ensure that safe harbour is not abused by directors seeking to avoid liability? For example, would time limits on the advice and/or any subsequent actions limit abuse of the process or simply hinder the process itself?*
- *Should companies (or individual directors) only be able to access safe harbour a limited number of times in a given time period — for example once every 3 years?*
- *What interaction should there be between safe harbour processes and any other subsequent insolvency process should restructuring fail or not be pursued? Particularly, should insolvent trading be simpler to prove where safe harbour requirements have not been properly followed?*

One potential outcome of a safe harbour could be a recommendation by the adviser that the company, or a significant part of it, be sold. This could create a process analogous to the current practice in the United Kingdom (box 15.2) of 'pre-packaged' sales (or 'pre-packs'), wherein preparatory work is done in advance but the sale is conducted at the beginning of a formal administration (before all creditors have been told about the business' failure).

ARITA noted their preference for 'pre-positioning', which they argued should be reviewed by an insolvency practitioner:

> For a number of reasons, including independence, whether the sale is for value and the lack of creditor involvement … we do not consider that a UK pre-pack process would be suitable for Australia. However, we see that there is a role for 'pre-positioning' in the Australian insolvency context. … [pre-positioning is] work done prior to a statutory insolvency appointment, with directors taking advantage of the safe harbour protections, subject to meeting the criteria for eligibility, to undertake an orderly wind down of the company's operations – that is a well-managed process where assets may be realised for market value in a non-distressed sale – prior to making a formal insolvency appointment. (2014a, p. 26)

To support their argument that the UK pre-pack system should not be directly adopted in Australia, ARITA noted the high failure rate and low benefits to unsecured creditors from 'pre-packs' in the United Kingdom:

> Approximately 65 per cent of all pre-packs resulted in sales to related parties. … often with deferred consideration – resulting in relatively high failure rate of the 'newco' (92 out of 310 connected sales in the UK study had failed within 36 months – 30 per cent; increasing the 37 per cent failure rate if there was also deferred consideration).
>
> The UK experience indicates that in 60 per cent of pre-packs there was no distribution to unsecured creditors, so therefore in the majority of pre-packs there is no benefit of the process to unsecured creditors. (2014a, p. 33)

ARITA's pre-positioning option adapts the United Kingdom process but introduces elements of independence such that:

- Any advisor retained by the directors in the pre-positioning phase cannot subsequently be appointed in any formal insolvency administration. This is consistent with the current and appropriate, independence requirements for insolvency practitioners in Australia.
- Any sales that occur in the pre-positioning phase must be for value and would be subject to review in any subsequent statutory insolvency administration.
- Any sale of assets undertaken during the statutory insolvency administration, where the terms of sale were negotiated in the pre-positioning phase, would be subject to review by the external administrator prior to being effectuated and the external administrator would be subject to the currently existing statutory and professional requirements regarding the sale of assets. (ARITA 2014a, p. 26)

Box 15.2 Pre-packaged sales in the United Kingdom

The 'pre-pack' process in the United Kingdom is not an intentional feature of the insolvency system created by any specific legislative reform. As the United Kingdom's Graham Review of pre-packs noted:

> The 1986 Act's administration provisions, … do not make any reference to pre-packing. Case law had however established that pre-packing was permissible by law both for old, pre-Enterprise Act 2002, administration and the administration law that exists today. But nowhere in statute is pre-packing defined or referred to. It is however a widely understood concept. Our working definition of pre-packing is: 'Arranging the sale of all or part of a company's undertaking before formal insolvency is entered, with the sale to be executed at or soon after the appointment of an administrator.' (Graham 2014, p. 14)

Although they have been the subject of much policy focus, pre-packs are not common in the United Kingdom, making up 3 per cent of insolvencies and less than a quarter of a per cent of all exits:

> Every year some 250,000 businesses disappear from the Companies House register. Of those around 20,000 go through an insolvency procedure and about 600 to 700 of those are pre-packed. The pre-pack numbers [3 per cent of insolvencies] are relatively small but the lack of transparency and trust in the process means that the 'noise' surrounding them is far greater than should be the case. (Graham 2014, p. 4)

A recent review of pre-packs in the United Kingdom noted concerns with the transparency of the process, and the lack of marketing of the sale of a business (lowering the sale price). The review also noted that pre-packs had benefits compared to more formal insolvency processes, notably that they are cheaper (in part due to lower court involvement), stand a better chance of preserving jobs and that deferred consideration (payment by purchasers occurring over time rather than at time of purchase) under pre-packs had a high rate of payment, to the benefit of existing creditors. Overall, the review did not recommend banning pre-packs, but rather some improvements to the existing process 'all of which require action on the part of insolvency regulators and the insolvency profession rather than government' (Graham 2014, p. 5).

ARITA noted their concerns relating to a lack of independent overview within the United Kingdom model:

> In the UK pre-packs are undertaken through the Administration process, whereby an administrator can be appointed by the company, the directors or by the holder of a qualifying floating charge out of court. Immediately after appointment, the administrator transfers the business for a pre-agreed price without the need for a creditors' meeting to be called to consider the terms of the deal. The administrator then distributes the proceeds of sale. If there is no money for unsecured creditors, the administrator can immediately file for the dissolution of the company. If there are funds for the unsecured creditors, the administrator will usually be appointed as liquidator to make the distribution to unsecured creditors and then dissolve the company. In either situation, there is no independent insolvency practitioner undertaking a review of the steps taken. (2014a, p. 32)

The Commission shares ARITA's concerns regarding the lack of transparency in the United Kingdom system, and the potential impact this could have in facilitating 'phoenix' activity (discussed below). However, the added independence from using a pre-positioning system would also come at a cost, as the review process would introduce administrative costs and delays. More importantly to many business transactions, a third party review of a deal introduces delays, costs (such as practitioners' fees) and potential uncertainty into the process, and could drive down the business sale price.

Overall, the Commission considers that the added independence, particularly on the part of the insolvency practitioner will be of value, especially in cases involving related parties.[51] However, not all related party transactions are necessarily designed to avoid liability. In some instances a related party may simply be the most natural purchaser available for the business — a director striking out on their own, or a large shareholder or creditor acquiring a business of interest to them (current competition laws relating to mergers and acquisitions that could substantially lessen competition in a market would continue to apply).

Additionally, there is already a substantial body of regulation and process that must be complied with for a company (and its directors) to go ahead with a related party transaction. This includes the general obligations for directors to not abuse their position to gain advantage for themselves or someone else (ss182 and 183 of the Act), the specific requirements for related party transaction (Chapter 2E of the Act), ASIC's Regulatory Guide 76: Related party transactions (ASIC 2011), case law and, for listed companies, Chapter 10 of the ASX listing rules.

The Commission is mindful of the potential for legitimate and beneficial transactions to be collateral damage from excessive regulation intended to target illegal activity. Rather than impose an additional level of regulation on related party transactions, the independent review and approval of a pre-positioned sale by an external administrator could be taken to be evidence that a related party sale is of value to the company and falls within the 'arm's length' exception under s210 of the Act.

To strike a balance between expedience and certainty for the sale of businesses, and independent review aimed at preventing illegitimate transactions, the Commission proposes a 'two-tier' system for pre-positioned sales. The process would differ depending on whether any related parties were involved (a determination made by the administrator):

- If no related parties are involved, there is a presumption that sale should go ahead, unless the administrator can prove that it was not for an amount within a reasonable range around market value (accounting for other reasons that the sale might be below market value such as the necessity for a quick sale, and a potentially limited pool of buyers).
- If any related parties are involved, there is no presumption favouring sale and the administrator's examination continues as normal, bearing in mind if the company has already complied with the body of related party regulations discussed above.

51 ASIC defines a 'related party transaction' as: 'any transaction through which a public company or registered managed investment scheme provides a financial benefit to a related party (such as a director, their spouse and certain other relatives). Almost by definition, related party transactions involve conflicts of interest because related parties are often in a position to influence the decision of whether the benefit is provided to them, and the terms of its provision' (ASIC 2011, p. 4).

DRAFT RECOMMENDATION 15.3

Provision should be made in the *Corporations Act 2001* (Cth) for safe harbour periods to result in 'pre-positioned' sales (where a non-distressed sale is organised in the period immediately prior to a formal insolvency appointment).

- External administrators in subsequent insolvency processes should have the ability to review the sales, and where there are no related parties, overturn them only if they can prove that the sale was not for reasonable market value.
- If there are related parties, there is no presumption favouring sale and the administrator's examination of the sale process continues as normal. The administrator's review should include checks that the sale has met existing regulatory requirements for related party transactions.

15.2 Facilitating restructure

While the options recommended are intended to improve the timing of restructuring processes, there are still obstacles to their success once initiated. As discussed in chapter 14, only 28 per cent of Deeds of Company Arrangement have been found to result in a successful restructuring (Wellard 2014). While there is likely a 'selection bias' in these data — that is, financially healthy companies are less likely to enter voluntary administration in the first place — this low rate of success nonetheless suggests there is scope for improvement.

Maintaining contracts during restructure

An ipso facto clause is a contractual clause that gives one party the right terminate their obligations in specified circumstances. A common form (found in supplier contracts, franchise and licence agreements, as well as leases) is that the contract may be terminated solely due to the party entering into insolvency (including voluntary administration). Importantly, such clauses do not relate to standard breaches of contract performance — payments could be made on time and goods or services delivered in accordance with the contract and yet the fact of insolvency could lead to termination.

Ipso facto clauses can and have been known to significantly lower the value of a business as, for example, supply of a retailer's inventory can be withdrawn, removing vital options that could assist in a restructuring process. Hindering a restructure by terminating contracts can effectively end the business, as well as any hope of selling it as a going concern, and reduce or even eliminate returns to creditors in an ensuing liquidation. ARITA noted the detrimental impact that such clauses have had in the past:

> Ipso facto clauses have played a pivotal role in the shutdown of major organisations that were in financial distress (examples such as the carrier contracts of One.Tel being terminated soon

> after the company entered voluntary administration resulting in One.Tel being unable to provide services to its customers, are obvious). (2014a, p. 18)

In cases of personal insolvency, under s301 of the *Bankruptcy Act 1966* (Cth), ipso facto clauses are rendered void if the party bound by the contract becomes bankrupt. No such general clause exists for ipso facto clauses in corporate insolvency under the Corporations Act. Instead, s440B of the Act restricts only the rights of property lessors and owners and secured creditors, but not contracts more generally.

Participants argued for a moratorium on ipso facto clauses — that is, that such clauses would be rendered void (unenforceable) against voluntary administrators, at least for the period of an administration. That is, as long as an administrator controls the company, the clauses would have no effect and a contract could not legally be terminated solely due to the insolvency. Such a moratorium could improve the chance that a restructuring process succeeds by preserving the business and its contracts as they were immediately before insolvency was formally entered.

There was broad support amongst participants for such a reform with parties including ASIC (sub. 20), the AICD (sub. 3), CCIQ (sub. 8), and Arnold Bloch Leibler (sub. 23) noting their detrimental impact and supporting changes to limit ipso facto clauses. Typifying these views, McGrathNicol argued that reform to ipso facto clauses was the 'single most important issue requiring resolution to ensure that the voluntary administration legislation achieves its intended objectives' (sub. 34, p. 4). Further, the last major review of Australia's insolvency regime, the Harmer report (ALRC 1988) also recommended that ipso facto clauses be void against a liquidator or administrator.

However, a more recent review into rehabilitating large companies by CAMAC (CAMAC 2004a) considered that the arguments against changes to enforcement of ipso facto clauses were strong. Briefly, these arguments were:

- counterparties may draft contracts around any ipso facto moratorium to achieve the same effect, but just before insolvency
- further restrictions on the rights of secured creditors may increase the cost of finance for all companies
- the importance of counterparties' rights in voluntary administration
- the difficulty in precisely defining what is, and is not, an ipso facto clause
- the commercial consequences to counterparties may outweigh any benefits to companies in voluntary administration (CAMAC 2004a, p. 72).

On balance, the Commission does not find these arguments compelling. As Ferrier Hodgson identified, the existing regime already curtails secured creditors' rights (under s440B) and the liabilities imposed upon administrators also provide some protection to suppliers:

> The existing voluntary administration regime limits secured creditors from enforcing their rights to possession of secured assets for a limited period. Prohibiting enforcement of ipso facto clauses during voluntary administration would not further impinge a secured creditor's rights. To that end, we also note that if an administrator is trading the business during the voluntary administration process, the administrator is personally liable for that trading. That personal underwriting would not disappear if, for a period of time, ipso facto clauses were not able to be triggered. (Ferrier Hodgson 2014, p. 12)

The Commission considers that ipso facto clauses should be identified by a purposive test (that is, the clauses should be identified by what they intend to do, rather than any exact wording they may contain). That is, does the clause have the effect of bestowing upon one party the right to terminate the contract *solely due* to the fact that the company has entered voluntary administration. To combat the risk of 'drafting around' the moratorium, the Commission considers that ipso facto clauses should be unenforceable during any sort of restructuring process, be it voluntary administration, schemes of arrangement or other future processes (such as the safe harbour recommended above). At this stage, the Commission does not propose to extend the moratorium to liquidators, as — unlike restructuring — by the time liquidation has commenced the prospect of the business continuing (in some form), and the supplier being repaid has all but disappeared.

In relation to detriment to other parties in a contract, contract law already allows for contract termination if a breach has occurred, including non-payment. The Commission does not propose any change to this. It may also be possible to adopt some safeguards to further reduce the risk of substantial damage to counterparties.

The United Kingdom has recently moved to prevent ipso facto clauses being enforced by providers of essential services (utilities and IT) in order to facilitate the restructure of businesses by insolvency practitioners. As part of this, three safeguards were introduced to ensure that suppliers can have confidence that they will be paid:

1. The supplier will be able to seek a personal guarantee from the insolvency practitioner at any time to give them more certainty that the supplies will be paid for.
2. The supplier will be able to apply to court to terminate their contract on the grounds of 'hardship'.
3. Guidance will be issued to insolvency practitioners to urge them to make contact with essential suppliers at the earliest possible time following their appointment to discuss their needs in relation to supply, to ensure that undue costs are not incurred. (Swinson 2015)

The Commission is mindful of some of the concerns that have prevented any moratorium on the enforcement of ipso facto clauses from being adopted to date. It considers there is merit in adopting safeguards to ensure that changes made to improve restructuring do not have unduly harsh impacts on suppliers. While the existing administrator's liability for trading debts they incur already mimics the 'personal guarantee' adopted in the United Kingdom, the Commission considers that there should also be the ability to apply to court to terminate contracts in extenuating circumstances. Guidance notes to insolvency practitioners to encourage engagement with suppliers also appears to be a relatively simple way of avoiding potentially large costs.

DRAFT RECOMMENDATION 15.4

The *Corporations Act 2001* (Cth) should be amended such that *ipso facto* clauses that allow termination of contracts solely due to an insolvency event are unenforceable if a business comes under the control of an administrator or receiver (as already applies if a person is in bankruptcy) or if the company is utilising the safe harbour arrangements set out in draft recommendation 15.2.

In circumstances where this moratorium could lead to undue hardship, suppliers should be able to apply to the Court for an order to terminate the contract.

INFORMATION REQUEST

The Commission seeks participants' views on any protections that would be required to ensure contractual 'work arounds' do not undermine the intent of draft recommendation 15.4.

In particular, is there international evidence of regulatory systems where the enforcement of ipso facto clauses has been successfully suspended during an external administration? Are there examples of work arounds that have undermined this? In these cases, have the work arounds been significantly detrimental to any later formal restructuring process?

Streamlining the process for schemes of arrangement

As noted in chapter 14, the current process for schemes of arrangement consists of six separate steps, an administratively onerous process requiring court involvement at two separate stages. This process, combined with the ability of creditors to undermine schemes through threat of action creates little incentive for their use, as is borne out by their relative scarcity in Australia.

As noted above, the Commission considers that the moratorium on ipso facto clauses should extend to schemes of arrangement to facilitate restructuring. Some participants argued that the general moratorium on creditor enforcement that applies to voluntary administration should also be extended to schemes of arrangement:

> In order [to] enhance the utility of schemes as a means of reorganising distressed but not insolvent companies, we believe that a moratorium on creditor enforcement actions (subject to Court supervision) be introduced into s 411 of the *Corporations Act*.
>
> The moratorium would take effect from the date that a compromise or arrangement is 'proposed' by the filing of the court application for orders convening meetings of the

> company's creditors and/or members in accordance with s 411(1) of the *Corporations Act*. Similar to the position in voluntary administration, the moratorium would be subject to abridgment by the Court or the consent of the company. (Arnold Bloch Leibler, sub. 23, p. 12)

While the Commission agrees with this view, a streamlined processes could open the door for some abuse of schemes. In such circumstances, the fact that creditor's actions are only 'paused', not extinguished, could provide an important counterbalance.

INFORMATION REQUEST

Should a moratorium on creditor enforcement actions during schemes of arrangement be introduced?

What effects would this have in light of some of the Commission's other proposed reforms. Specifically, would it have a substantial additional impact on the effectiveness of schemes over and above a moratorium on ipso facto clauses? Would removal or streamlining of court involvement affect the benefits available?

Arnold Bloch Leibler also proposed a 'reconstruction panel' that could be used to generally reduce the requirement for formal court processes:

> A reconstruction panel would address the concerns raised by the Commission in the Issues Paper regarding the costs associated with formal court processes … Along with a reduction in cost, an expert panel would assist parties to reach commercially sound and pragmatic outcomes, as the members of the panel would be persons of relevant experience, such as insolvency practitioners, investment bankers, corporate advisors and lawyers practising in the field of insolvency. As such, the panel members would have the capacity to understand and to adequately balance the interests of all stakeholders. (sub. 23 p. 10)

To avoid constitutional issues, such a panel could function with a restricted ambit, similar to the Takeovers Panel, and matters could be referred to it by the Federal or Supreme Courts for an opinion in a manner similar to expert witnesses or referees (Arnold Bloch Leibler (sub. 23). The panel would essentially replace Court oversight of schemes of arrangement.

While the Commission is attracted to options that reduce the costs that come with court involvement, it is also wary that the introduction of a new process is not itself costless. Legislation must be introduced, panel members must be recompensed and the panel would need to be housed (or at least have a secretariat if matters are conducted remotely). As McGrathNicol argued, a panel:

> … has academic merit in certain circumstances we suspect that it would in fact only be preferable to the current mechanisms in a small number of cases in Australia such that the cost and disruption of implementing the change renders it impractical. (sub. 34, p. 4)

The Commission intends to explore in the final report where the balance of costs and benefits from the introduction of a panel would fall.

INFORMATION REQUEST

Is there scope for additional use of alternative dispute resolution and other non-judicial options within the insolvency process? Is this possible under current law, would it require legislative change or would constitutional issues affect its design? In particular:

- *Would an 'insolvency panel', operated as a form of expert witness, reduce costs in insolvency process, particularly when considered alongside the Commission's other reform proposals? How could this be implemented?*
- *Should any panel be able to hear matters across all insolvency issues, or would some subset, such as schemes of arrangement, be more appropriate?*
- *How many court hearings would such a panel displace? Would this represent a wholesale replacement of the court, or simply an addition (in time and cost) to existing processes?*

15.3 Reforming the winding up process

Not all businesses will be candidates for or successful users of restructuring. For those businesses that fail, the focus of an efficient system should shift away from corporate survival and towards a balance between expedient winding up and an orderly process that also functions as an enforcement tool to discourage breaches of directors' duties and other illegalities. The changes discussed below are intended to move the current system towards these goals.

Insolvency processes — does one size fit all?

The current liquidation process serves a range of functions — ascertaining the remaining assets in a company, distributing available funds among creditors and investigating any potential wrongdoing that may have occurred, including whether the liquidation is a component of illegal phoenix activity (discussed below).

Performing this range of roles is not costless. But, as identified in chapter 14, a significant proportion of liquidations involve companies with few assets (41 per cent are 'assetless' at the time of insolvency, and a total of nearly 80 per cent have less than $50 000 assets at insolvency) and relatively small liabilities (43 per cent of failed companies had estimated liabilities of $250 000 or less, and 76 per cent of failed companies had estimated liabilities of less than $1 million). In these circumstances a detailed investigation by a liquidator will incur legitimate costs that can (more than) consume the remaining assets — leaving creditors with no returns and insolvency practitioners bearing the costs (requiring them to cross-subsidise with other activities in order to remain profitable themselves).

A major component of these costs is the degree of investigation required. Current requirements are not proportionate to the size of the company, assets or liabilities involved, as the regulator (ASIC) noted:

> Current insolvency laws currently take a, 'one size fits all' approach; with the same duties and obligations imposed on the external administrator regardless of the size and complexity of the external administration. Industry has argued that the cost of administering small- to medium-size enterprises is high and often the external administrator is required by current law to undertake tasks (investigations and reporting to creditors and ASIC) in circumstances where there are insufficient assets to pay the costs of this work.
>
> ASIC submits that opportunity exists to improve and streamline the external administration of small- to medium- size enterprises and their regulation, so as to reduce the cost of external administration and encourage competition without undermining confidence in the insolvency regime. (sub 20, p. 39)

Investigations by liquidators are not always followed up by the regulator (often with good reason). Indeed, of the 7218 external administrator reports that identified possible misconduct in 2013-14 (out of a total of 9459 reports):

> External administrators confirmed they had documentary evidence to support alleged pre-appointment misconduct for 4,446 reports (47 per cent) for 2013-14 … Of these, they considered that only 1,483 reports (15.7 per cent) warranted ASIC's inquiry into the alleged misconduct, based on their assessment of the information and documentary evidence available. … Of the 1,483 reports … [ASIC] requested supplementary reports (or Schedule C reports) for 345 of those matters (23.3 per cent). We requested a further 457 supplementary reports (802 in total for 2013-14) where external administrators had not recommended further inquiry but the matter met our risk assessment criteria … (ASIC 2014a, pp. 23–4)

In effect, a filtering process based on risk management is being used by the regulator, but the industry is prevented from applying similar criteria by regulations requiring the same degree of investigation and reporting regardless of a company's size.

Those within the industry, including McGrathNicol (sub. 34), supported the creation of a 'streamlined' option for small liquidations and (ARITA) has developed a model for a streamlined process (box 15.3). The Commission generally supports ARITA's model, with a few exceptions.

The Commission considers that ARITA's model should be amended to include the scope for ASIC to intervene to convert a streamlined process into a full liquidation. However, where it does so, ASIC should then fund the liquidation process through its Assetless Administration Fund (discussed below). This should ensure that creditors who would prefer an expedited process are not unduly disadvantaged by enforcement actions, and that practitioners are appropriately remunerated for a more efficient level of service provision.

Box 15.3 ARITA's model for streamlined liquidations

As part of their 2014 policy paper, the Australian Restructuring Insolvency and Turnaround Association put forth the following model for streamlined liquidation:

> A new streamlined liquidation process would differ from the current liquidation requirement as follows:
>
> - removal of requirement to call meetings, report to creditors, undertake investigations into the company and officers' conduct and complete statutory reporting (e.g. s 533 report)
> - expedited dividend process:
>   - Streamlined proofs of debt dealing process for debts under $10,000
>   - No tax clearance required from the Australian Taxation Office where the dividend is less than $25,000 (10 per cent of maximum liability amount) or 10 cents in the dollar, and
>   - Streamlined advertising and notice requirements for dividends less than $25,000 (10 per cent of maximum liability amount) or 10 cents in the dollar, and
> - fixed fee set by government for this type of liquidation, no remuneration accounting or approval.
>
> In order to protect the rights of creditors and the integrity of the regime, the streamlined liquidation process would incorporate provisions whereby:
>
> - the liquidator would report to creditors on appointment and gives them the option of converting the streamlined liquidation into a full creditors' voluntary liquidation (i.e. where normal investigating and reporting obligations apply and remuneration of liquidator is given priority in the normal way)
> - if a majority of creditors (excluding related party creditors) vote for this to occur then it converts and the Liquidator does not have the power to convert to a full liquidation without this consent
> - if the liquidator subsequently becomes aware of a matter which may warrant investigation, they can again seek creditor directions (including resolution by circulation, if appropriate) as to whether the liquidation should convert to a full liquidation, and
> - if liabilities at any time in the process exceed $250,000 to unrelated entities the streamlined liquidation process would no longer be available and the existing creditors' voluntary liquidation requirements would apply. (ARITA 2014a, pp. 23–4)

While ASIC support streamlining in general, they have noted a risk that this could impinge on enforcement activities:

> ASIC would be concerned if a streamlined liquidation process was introduced at the expense of liquidators properly performing their important function as gatekeepers of the financial system; for example, detecting and reporting on directors and others who engage in illegal phoenix activity. (sub. 20, p. 32)

The Commission agrees that enforcement considerations are important and could be undermined by a streamlined process. Nonetheless, enforcement activities should be based on risk management rather than absolute protections. Further, in situations where there is little if any recompense for the insolvency practitioner, not to mention creditors, it is particularly important that the cost follows the potential benefits. In this case, enforcement activities have benefits of a public nature (in contrast to efforts to recoup and distribute funds which are predominantly private benefits to the creditors).

A second exception to the ARITA model relates to practitioner remuneration. The Commission notes that court challenges to remuneration are a significant source of cost and delay during insolvency processes. Even in the absence of a challenge the approvals and record keeping required can be disproportionate to the assets and likelihood of wrongdoing involved. In the context of small liquidations tying up resources in this manner when there is so little at stake appears futile.

An alternative to variable remuneration is a fixed fee for insolvencies. However, the Commission is concerned about the effects that a fixed fee may have on competition in the market:

- if the fixed fee is set too low, there may not be enough supply (resulting in delays as companies 'wait' for the next available practitioner),
- if the fixed fee is set too high, then rents may accrue to providers at the expense of creditors.

Instead of fees set by government, the Commission proposes the use of a 'pool' of insolvency providers. These providers and their associated fees would be determined by ASIC through a tender process. While there would be administrative and compliance costs involved, a pool model would preserve competition and allow innovation on the basis of fees (hourly, fixed, event based or a hybrid form).

A further concern in liquidation is the independence of the practitioner — a particular concern is where a 'friendly' practitioner is brought in to facilitate a speedy liquidation as part of a greater illegal phoenix process. In large liquidations, sophisticated (and well-funded) creditors would have the capacity to maintain oversight of the practitioner and, take action to replace them. In contrast, small liquidations are more likely to involve less sophisticated creditors who may need protection on independence grounds.

To preserve a greater degree of independence, the Commission considers that a 'next cab off the rank' system from the pool of providers (administered by ASIC) should be used for small liquidations.

DRAFT RECOMMENDATION 15.5

The *Corporations Act 2001* (Cth) should be amended to provide for a simplified 'small liquidation' process.

- This would only be available for those companies with liabilities of less than $250 000, creditors would be able to opt out of the process and into a standard creditors' voluntary liquidation, and the Australian Securities and Investments Commission (ASIC) would be able to initiate further investigation if it has concerns of illegality.
- The primary role of the liquidator would be to ascertain the funds available, to a reasonable extent given a reduced timeframe.
- In line with this, there would be no requirement for meetings of or reports to creditors, nor investigations into officers' conduct or other illegalities (unless ordered, and recompensed, by ASIC).
- Liquidators for these processes would be drawn from a pool of providers selected by tender to ASIC. The tenders would be subject to review every five years.

Further, the current Insolvency Law Reform Bill 2014 appears to introduce valuable reforms for professional regulation in relation to quality and competence issues as well as streamlining some regulatory processes. However, the increased degree of power that the bill vests in creditors may be inconsistent with streamlined liquidation processes.

Finally, as noted above, directors of small companies face different incentives and respond differently to (typically professional) directors of large companies. This can limit the effectiveness of present laws drafted with sophisticated directors in mind.

INFORMATION REQUEST

The Commission seeks participants' views on matters relating to the implementation of draft recommendation 15.5:

- *What should the threshold be for a company to be subject to a small liquidation?*
- *To what extent can the proof of debt and advertising requirements be reduced for small liquidation?*
- *How would the small liquidation process interact with reforms under the Insolvency Law Reform Bill 2014 (Cth)? Will these interactions require further changes to the Bill?*
- *Should changes be made to directors' duties in line with the proposed small liquidation threshold?*

The role of secured creditors

Secured credit has been a longstanding element of the Australian financial system, and consequently, receivership has been a longstanding feature of the insolvency process. The AICD noted the impact that the enforcement of a secured creditor's rights can have on the prospect for a successful restructuring, particularly during a voluntary administration:

> While the rights of other secured creditors in a voluntary administration are subject to a moratorium, the right of a substantial secured creditor to enforce their security in the [13 day] decision period remains. If a substantial secured creditor appoints a receiver or takes possession of a large component of the company's property, little prospect remains of rescuing the company or preserving the value of the business as a going concern. In this way, the regime provides an incentive for substantial secured creditors, to act in their own self-interest and arrange for the disposal of key assets. (sub. 3, p. 7)

Receivers act with the interests of the secured creditor in mind, preserving or realising the asset in question. For substantial assets (such as the businesses premises or a core piece of factory or farm equipment), this could result in 'ripping the heart' out of a company, ruining any chance of restructuring or forcing a piecemeal, rather than going concern, sale of the business. This is also contrary to use of a group process to prevent business value destruction by parties seeking to rush to court (chapter 14).

The AICD advocated 'some restrictions on the rights of substantial secured creditors to immediately enforce their security during the voluntary administration process' (sub. 3, p. 7). Currently, the moratorium on creditors' actions during a voluntary administration is subject to an exception that allows a substantial secured creditor to enforce their security (including by appointing a receiver) within 13 business days (the 'decision period') from the appointment of an administrator (s441A of the Act). Arnold Bloch Leibler submitted that where the security is enforced, the opportunity for successful rehabilitation is 'invariably lost' (sub. 23, p. 9) due to the focus on realising a single asset rather than the benefit of all stakeholders, and noted that the decision period can be extended:

> Under the current statutory regime, secured creditors and administrators often extend the 'Decision Period' by agreement so that the secured creditor retains the ability to appoint a receiver 'over the top' of the administrator at any time during the administration. By doing so the secured creditors exercise a defacto negative control over the administration. That is if it does not approve of the conduct of the Administrators it will appoint a Receiver over the company. This can inhibit the ability of the administrator to pursue the rehabilitation purposes of Part 5.3A and convert the administration into a *de facto* receivership. (sub. 23, p. 9)

To remedy this, Arnold Bloch Leibler suggested prohibiting extensions to the decision period unless they were approved by a Court (or specialist panel) (sub. 23, p. 7). While the Commission considers that this is likely to be an improvement on the present system, it also notes that it does not curtail the ability of receivers to affect restructuring efforts or the net returns to other creditors (the gross realisations from the sale less the costs of the insolvency process).

In the United Kingdom, reforms in 2003 (box 15.4) essentially removed receivership as an option in insolvency, effectively converting any receivership process to a broader administration. The reforms were intended to increase the likelihood of restructuring and, should that fail, improve the value obtained by creditors as a whole.

However, an evaluation of the UK reforms found that increased recoveries in administrations were consumed by higher costs and sophisticated secured lenders found ways to work around the legislated changes. The Commission is seeking to find a balance between the secured creditors' right to retain priority, and their entitlement to the value of the asset, and the effect this could have in jeopardising the overall value of a company. Informed by the relative benefits and pitfalls of the UK experience, rather than abolishing receivership, the Commission sees some value in restraining the ability of receivers to jeopardise the overall value of the company.

The Commission considers that changes should be made to the powers and duties of receivers to remove their ability to unilaterally force the sale of an asset that could otherwise contribute to the continuation of the business, or an improved overall sale (that is, sale of the business or some subset as a going concern). Importantly, the Commission sees these restrictions as only being available in circumstances where other creditors could be materially affected. Therefore, where the secured creditor has security over all (or substantially all) of the business, this modified process would effectively mimic existing receiverships.

Box 15.4 Secured creditors in the United Kingdom

Introduced in 2003, the *Enterprise Act* made major changes to the insolvency process in the United Kingdom. Prior to the Act, the system in the United Kingdom was analogous to Australia's and involved corporate voluntary arrangements and schemes of arrangement (restructuring mechanisms based on creditors' vote), administration, receivership and liquidation. The changes in 2003 curtailed the power of secured creditors by effectively abolishing receiverships, instead allowing secured creditors to appoint an administrator:

> However, the administrator is much more widely accountable than a receiver. He must seek to implement a hierarchy of objectives: in the first instance, to rescue the *company* as a going concern; failing that, to achieve a better return for the creditors as a whole than in liquidation; and failing that, to realize collateral for the benefit of secured and preferential creditors. Thus, in contrast to a receiver, an administrator is statutorily obliged to try to achieve a value maximizing "rescue" – either of the *company* or the *business* – if he can. This duty is supplemented by two further express duties on the administrator: (i) a duty to perform his functions in the interests of the company's creditors as a whole and (ii) a duty to perform his functions "as quickly and efficiently as is reasonably practicable". In addition, his proposed course of action must be approved by a simple majority vote of the unsecured creditors. (Armour, Hsu and Walters 2008b, p. 160)

An empirical evaluation conducted in 2008 of 102 receiverships (pre-reform) and 182 administrations (post-reform) found that the reforms were only partially successful:

> … our principal finding is that both gross realizations and direct costs are higher under the new streamlined administration procedure than under receivership. This implies that the increased recoveries in administration cases may have been eaten up by increased costs, which inference is supported by the general lack of any statistically significant increase in net recoveries to creditors under the new administration procedure. (Armour, Hsu and Walters 2008b, p. 170)

The authors suggested two potential reasons for the increase in the costs of insolvency process. First, their sample was taken from administrations conducted immediately after a major reform (from 15 September 2003 when the changes were enacted to 31 December 2004), as such there may have been 'learning' costs as practitioners adjusted to new regulation. Second, and perhaps more compelling was the implication that concentrated control by a (sophisticated) secured creditor is better suited to controlling costs. In regard to simple administrative costs, reporting and meeting requirements would be lower with just one counterparty, and there would not be costs associated with conducting votes of creditors. Further, the sophisticated secured creditor may be more able to oversight the activities of an insolvency practitioner and keep a rein on any unnecessary costs.

A further issue with the UK reforms is that removal of one option does not always reduce the power of the secured lender. Indeed, sophisticated parties are well placed to find means of working around legislative change:

> … in markets where the traditional enforcement rights of secured lenders have been removed, new mechanisms have evolved to provide that secured lending status. For example, we understand that in the UK, secured creditors are the significant beneficiaries of the pre-pack regime that has developed there, with unsecured creditors rarely receiving any distribution. (ARITA, sub. 31, p. 18)

In order to achieve this, the Commission proposes that:

- Receivers' duty to obtain the best price for a company asset sale should be subject to a duty not to cause unnecessary harm to the interests of creditors as a whole, including not putting the continuation of the company, or the preservation of the company as an ongoing concern for sale purposes, at risk. Unlike the United Kingdom system, the Commission considers that it is not the role of a receiver to maximise the benefits to all creditors, but instead to protect the value of the secured credit.
- The existing powers of a receiver should remain. However, any proposed action (particularly involving sale of assets) that are outside the normal course of the debtor's business, would be subject to a simple majority vote of all remaining creditors. This vote would be waived if, in the receiver's opinion, there would be no funds to distribute to unsecured creditors after secured creditors are paid.

There is a risk that such changes may affect the cost of finance. However, these changes would not diminish the power of receivers to protect the secured creditor's assets, nor would they affect the secured creditor's rights to the proceeds of the sale of those assets. Instead, the changes only install hurdles that prevent unilateral sales that could harm the company or the broader class of creditors. Importantly, the duties only require prevention of *unnecessary* harm — cases where there is an imminent risk of a precipitate drop in the value of the asset would likely be judged by the courts as a *necessary* harm to other creditors. In principle, any reduction in value to secured creditors should be minor.

DRAFT RECOMMENDATION 15.6

The *Corporations Act 2001* (Cth) should be amended to alter the powers and duties of receivers:

- The duties to obtain best prices under section 420A should be subject to a duty not to cause unnecessary harm to the interests of creditors as a whole, including putting the continuation of the company, or the preservation of the company as an ongoing concern for sale purposes, at risk.
- The existing powers of a receiver should remain. However, any proposed courses of action, particularly involving sale of assets, that are outside the normal course of the debtor's business, would be subject to a simple majority vote of all creditors. This vote would be waived if, in the receiver's opinion, there would be no funds to distribute to unsecured creditors after secured creditors are paid.
- Secured creditors would retain the right to appoint receivers as dictated by the conditions of the security. Such appointments may not be overturned by simple votes of creditors, but may be overturned if the court determines that the receiver is not acting in accordance with the duties above.
- These changes would only apply to security contracts entered into after the date of assent of the amending legislation.

INFORMATION REQUEST

Is there any evidence that receivers have acted in a manner prejudicial to the interests of other creditors, or unduly threatened the continued existence of the business?

What evidence is there that the behaviour of secured creditors has changed over time? Has the use of receivers and liquidators reduced in preference to informal workouts?

INFORMATION REQUEST

What effect would the Commission's proposed reforms, specifically in draft recommendation 15.6 have on the cost of capital? Is this supported by evidence from similar reforms in other jurisdictions?

The Commission notes that consideration would also need to be given to any necessary changes to the *Personal Property Securities Act 2009* (Cth) in order to give effect to these changes and ensure that the interaction between the Corporations Act and the Personal Property Securities Act does not undermine the intent of this reform.

15.4 Broader aspects of winding up

The winding up process extends beyond corporate insolvency laws. Changes to those laws can have broad effects — for example on employees, or the ability to undertake illegal activity — that need to be considered alongside insolvency reforms.

Employee entitlements in insolvency

Under the Fair Entitlements Guarantee (FEG), introduced in 2012, the Australian Government provides financial support to eligible employees who lose their job due to their employer entering liquidation or bankruptcy. FEG is designed to operate as a last resort scheme (or safety net) where no alternative avenue exists for employees to be paid their accrued employment entitlements on redundancy due to liquidation or bankruptcy of their employer.

Australia is not alone in providing a publicly funded safety net for employees caught up in company insolvencies. Similar schemes exist in the United Kingdom (The Insolvency Service 2015), Denmark and Germany, though differing payment structures and ranking of creditors applies between countries (Johnson 2006).

Australian Government support is provided under FEG for five specific employment entitlements — unpaid wages, annual leave, long service leave, payment in lieu of notice and redundancy pay — subject to some caps. The Government then stands in the shoes of the employee as a creditor in the liquidation and attempts to recover its outlay as part of the winding up process. Employees are a special class of unsecured creditor with priority (in terms of their wages and associated entitlements) ahead of other unsecured creditors, and the floating assets of secured creditors (ss 556 and 561 of the Act).[52]

The FEG is the latest iteration of a Government employee entitlement scheme, and was preceded by the Employee Entitlements Support Scheme (EESS) which began in 2000 and the General Employee Entitlements and Redundancy Scheme (GEERS) which began in 2001 (table 15.1).

Table 15.1 **Australian Government employee entitlement schemes**

	Employee Entitlements Support Scheme (January 2000-September 2001)[a]	*General Employee Entitlements and Redundancy Scheme (GEERS) – initial form (September 2001-2006)*	*GEERS as amended (2006-December 2012*	*Fair Entitlements Guarantee (December 2012-)*
Unpaid Wages	Up to 4 weeks	Uncapped	Up to 3 months (November 2006)	Up to 13 weeks
Unpaid annual leave	Up to 4 weeks (accrued in the last year)	Uncapped	Uncapped	Uncapped
Unpaid long service leave	Up to 12 weeks	Uncapped	Uncapped	Uncapped
Payment in lieu of notice	Up to 5 weeks	Uncapped	Up to 5 Weeks (15 December 2008)	Up to 5 weeks
Redundancy pay	Up to 4 weeks	Up to 8 weeks	Up to 16 weeks (August 2006), then up to 4 weeks per year of full service (January 2011)	Up to 4 weeks per year of full service [b]

[a] Total payments under the EESS were capped at 29 weeks' pay, maximum overall amount $20 000. [b] Amendments are currently before the Australian Parliament to cap redundancy payments at 16 weeks.

Source: Department of Employment (2014)

52 A 'floating charge' (or 'circulating security') is not attached to any physical item of property but instead 'floats' above a category of the debtors' property — typically inventory and cash. The debtor is able to deal with the assets (selling stock) without consulting the creditor. A charge remains floating until a specific event occurs (generally some form of winding up commences or the creditor's security is imperilled) at which point the charge 'crystallises' and becomes a fixed charge. A fixed charge attaches to the property — it becomes an encumbered and will remain so until the debt is paid off, regardless of the owner. Floating charges can only be given by companies (Duns 2002, pp. 346–9).

FEG payments to employees of insolvent companies are significant. In 2013-14, 11 255 claimants were paid $197 million under the scheme (an average of just over $17 500), a marked increase from the $73 million paid to 8626 claimants (an average of just under $8500) in 2006-07. Unsurprisingly, the number of claims is dominated by small businesses (over 72 per cent in 2013-14), followed by medium businesses (nearly 27 per cent) with relatively few large businesses (less than 1 per cent). However, compared to their share of the overall stock of businesses (98 per cent) and of insolvencies (81 per cent), small businesses are relatively under-represented in the number of FEG claims.

In terms of amounts paid, medium businesses (with between 15 and 200 employees) dominate with a 63 per cent share, and small and large businesses with 19 per cent and 18 per cent respectively. The distribution of payments across industries from 2004-05 to 2013-14 shows that manufacturing employees (30 per cent) have consistently been major recipients, with construction employees (nearly 16 per cent) and retail trade industry employees also featuring (Department of Employment, sub. 12).

Moral hazard risks

As is common with forms of insurance, the provision of a safety net creates a 'moral hazard' risk as the parties involved no longer directly face the incentives provided by the true level of risk associated with their actions.

In the case of the FEG, employers may accept a higher level of business risk than they otherwise would, in the knowledge that employees would receive support in the event that the business fails. The Commission notes that s596AB of the Corporations Act allows action to be taken against directors who enter into transactions with the intention of preventing the recovery of employees' entitlements. However, the difficulty of proving intention behind a financial transaction has hindered the usefulness of the section, with some commenting that it 'has never been effectively used' (Anderson 2012, p. 422).

Similarly there is a risk that employees may not advocate thorough investigations by liquidators, and at the margin, the safety net could affect the views of directors and employees on the desirability of entering liquidation.

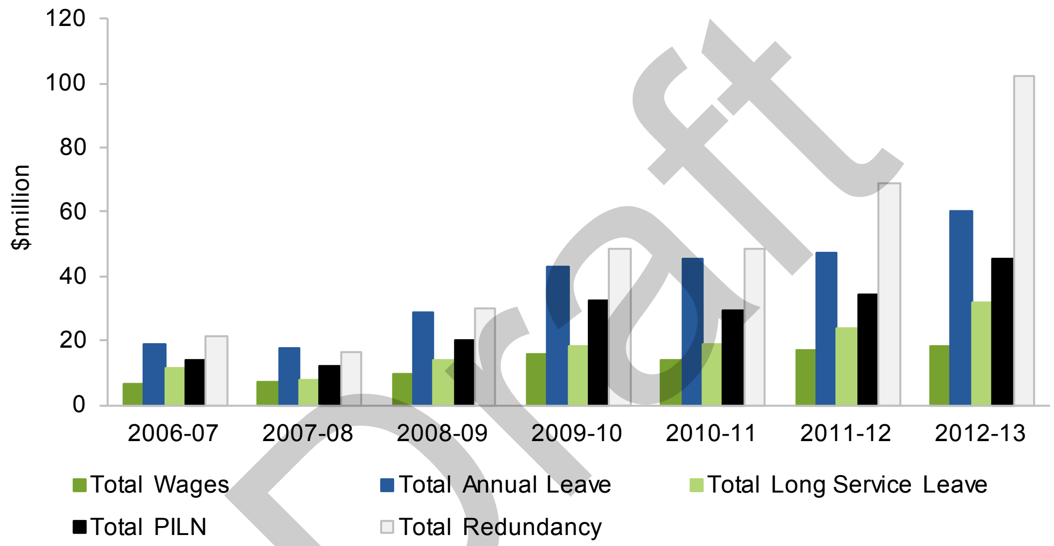
The Department of Employment (sub. 12) submitted that there was some evidence of moral hazard in the claims data from both FEG and GEERS.

- The proportion of insolvent entities for which FEG assistance is required has increased from 17 per cent in 2006-07 to 21 per cent in 2013-14 after peaking at 23 per cent in 2009-10.
- The proportion of workplace agreements that provide a total maximum redundancy payment of more than 16 weeks has increased from 23 per cent of agreements in 2011 (quarter one) to 32 per cent of agreements in 2014 (quarter 3). This may indicate that some employers are offering generous redundancy terms in Enterprise Agreements,

knowing that the Commonwealth can provide a safety net should they become insolvent.

The value of entitlements paid under the scheme for redundancy pay has increased disproportionately to other entitlements from 30 per cent of total scheme costs in 2006-07 to 39 per cent in 2013-14. In the last six months of 2014, redundancy paid to claimants accounts for 40 per cent of all entitlements paid under the scheme (figure 15.1). This suggests that the increased allowance for redundancy pay has increased the level of moral hazard relative to past versions of the scheme.

Figure 15.1 **Increases in FEG redundancy payments**[a]



[a] PILN: payment in lieu of notice.

Source: Department of Employment (2014)

The Australian Government is acting to cap redundancy payments in response to the increasing trend. The Fair Entitlements Guarantee Amendment Bill 2014 aims, among other things, to introduce a 16 week total cap on redundancy payments (replacing the current entitlement of 4 weeks per year of service). The explanatory memorandum for the Bill suggests that this change will result in an estimated saving of over $79 million from 2014-15 to 2017-18 (Fair Entitlements Guarantee Amendment Bill 2014, Explanatory Memorandum, p. 2).

Ability for the Australian Government to recover funds

In addition to capping categories of the payment, another potential counterbalance to any moral hazard issue is the role of the Australian Government as a creditor. In theory, given its size and ability to wield legal expertise, the Government should be better placed than a typical employee to act on any claims for entitlements owed during an insolvency. However, companies entering insolvency rarely have enough funds to pay all creditors — in 97 per cent of cases, the estimated payout to all unsecured creditors is less than 11 cents in the dollar (ASIC 2014a, p. 43). Indeed, since 2001, the Australian Government has only managed recovery rates (an average of 13.9 per cent) marginally greater than general unsecured creditors (table 15.2).

Table 15.2 **Payments and recoveries of employee entitlement schemes**

Financial Year	*Total assistance*	*Employees paid*	*Average payment per employee*	*Recovery amount*	*Recovery rate against amount paid*
	$ million	Number	$	$ million	Per cent
2001-02	62.6	10 595	5 912	1.5	2.5
2002-03	67.6	9 364	7 217	5.2	7.7
2003-04	60.4	8 699	6 940	5.2	8.6
2004-05	66.7	8 845	7 539	12.1	18.1
2005-06	49.2	7 162	6 876	26.0	52.8
2006-07	73.0	8 626	8 460	9.5	13.0
2007-08	60.8	7 808	7 784	16.8	27.6
2008-09	99.8	11 027	9 047	9.1	9.1
2009-10	154.1	15 565	9 898	18.7	12.2
2010-11	151.3	15 413	9 819	15.6	10.3
2011-12	195.5	13 929	14 038	21.4	10.9
2012-13	261.7	16 019	16 334	37.2	14.2
2013-14	197.2	11 255	17 521	19.1	9.7
2014-15 (at 28 February 2015)	176.4	10 447	16 886	13.4	7.6
Total	1519.0	156 848	9 685	210.8	13.9

Source: Data supplied by the Department of Employment.

If the Australian Government was a more capable and active enforcer of its (inherited) creditor's rights, it may not only improve its net budget outlay for the FEG, but could also reduce any moral hazard of company directors.

Some commentators have suggested means to improve the Australian Government's standing and overall recoveries. For example, Wellard (2013, pp. 5–6) suggested amendments to the insolvent trading provisions (s588G(1A)) of the Corporations Act list of deemed 'debts incurred' during the insolvent trading period to include accrual of employee entitlements, and to s560 of the Act to ensure that the Commonwealth steps into the shoes of employees as a creditor with *all* of the same rights as FEG recipients, rather than simply their status as a priority dividend ahead of other unsecured creditors.

Wellard also advocated the return of the 'Active Creditor Pilot' which provided funding to insolvency practitioners to thoroughly investigate a company and pursue legal action to realise additional funds for all creditors, including the Australian Government:

> … as at 31 August 2008, $733,546 had been returned to the Commonwealth and an additional $2,540,592 was anticipated to be returned to the Commonwealth as a result of the action taken in Pilot matters." … [there was] a total anticipated return to the Commonwealth of $3,276,540 from action taken under the Pilot against an outlay of $644,510. … the results of the Active Creditor Pilot (562 per cent return no less!) suggest that this is a potential investment which the Commonwealth might do well to reconsider in addressing FEG shortfalls. (Wellard 2013, p. 8)

The Department's own review (DEEWR 2008) also noted the success of the Active Creditor Pilot and suggested that its features be permanently adopted as part of the Australian Government's approach to recovering funds paid out for employee entitlements.

Other commentators (Anderson 2014) have also drawn attention to potential reforms, including changes to the strict limitations of ASIC's Assetless Administration Fund (discussed below).

The interaction of any reforms to improve the recovery of FEG entitlements with changes to the insolvency regime as recommended by the Commission (particularly safe harbour periods and any pre-positioned sales) would also need to be carefully managed.

A need for change?

While there are concerns around FEG, particularly regarding moral hazard issues, the counterfactual situation is a world of ad hoc government hand-outs, as existed before the assistance schemes were formalised. A commonly cited example is the case of National Textiles, a clothing manufacturer near Newcastle, New South Wales, that entered insolvency in January 2000, owing 314 employees slightly over $11 million in entitlements. While the Employee Entitlements Support Scheme was announced on 8 February 2000 to cover insolvencies after 1 January 2000, at the same time the government also announced special assistance for the National Textiles workers. This involved a grant of $4 million and an additional $2 million to fund retraining (Anderson 2014, p. 25). Such an ad hoc approach (from either state and federal governments) contributes to uncertainty, creates political pressure, and leads to accusations of unfairness:

> Why should a coal mine like Oakdale [liquidated in June 1999] receive the benefit of a well-resourced long service leave and superannuation fund, when a goldmine such as Woodlawn [which closed in March 1998] does not? Why should one textile factory, National Textiles, receive a special handout, when another, Braybrook Manufacturing, does not? Or why should one regional business, National Textiles, benefit from the Regional Assistance Scheme, when other regional businesses such as Scone Fresh Meats … a mere 115 kilometres [away] … must rely on the much less generous EESS? (Anderson 2014, p. 26)

In the Commission's view, the retention of a structured, predictable scheme is preferable to the situation that existed before the schemes. Participants in this inquiry noted that, not only was the FEG superior to alternative means of protecting employee entitlements, but that it had also 'significantly contributed to a reduction in industrial action in support of unpaid workers' (Anderson et al, sub. 1, p. 7).

In relation to improvements to the scheme, the proposed amendments to cap redundancy pay appear to be a proportional response to the clear increase in payments in that category and should proceed.

Further, the Commission considers that there is value in the Australian Government considering legislative amendments to the Corporations Act in order to improve its standing as a creditor. In particular, the returns obtained for the Active Creditor Pilot, while potentially reflective of a small sample of cases only, suggests that there are net benefits to the Australian Government from the pilot. Therefore, in line with the review of the pilot, the Commission considers it should become a permanent feature of the FEG (or any future employee entitlement scheme). As with all policies, particularly those involving the expenditure of public funds, the Commission considers periodic review of the performance of the scheme is appropriate, with the first review to commence in 2021.

DRAFT RECOMMENDATION 15.7

The Fair Entitlements Guarantee scheme should continue, with specific provisions subject to the passage of the Fair Entitlements Guarantee Amendment Bill 2014 (Cth) to alter the cap on redundancy payments in order to address the primary realisation of moral hazard issues.

The *Corporations Act 2001* (Cth) should be amended to allow the Commonwealth to play a more active role as a creditor. In line with this, the Active Creditor Pilot should become a permanent part of the scheme.

The operation of the Fair Entitlements Guarantee, in its entirety, should be reviewed in 2021 in order to monitor any moral hazard issues, potential abuse of the scheme and continued effectiveness of recovery arrangements.

Phoenix activity

An associated issue that contributes to the moral hazard than can arise due to the presence of the FEG, and the ability of the Australian Government to pursue recoveries, is the quarantining of assets and liabilities through so-called 'phoenix activity'.

While difficult to define precisely (Anderson et al. 2014), 'phoenix activity' refers to the creation of a new company 'from the ashes' of a pre-existing one. Importantly, phoenix activity is not in and of itself illegal — its legality hinges on the intent behind the activity:

> Legal phoenix activity covers situations where the previous controllers start another similar business, using a new company when their earlier company fails, usually in order to rescue its business. Illegal phoenix activity involves similar activities, but the intention is to exploit the corporate form to the detriment of unsecured creditors, including employees and tax authorities. The illegality here is generally as a result of a breach of directors' duties in failing to act properly in respect of the failed company and its creditors. (Anderson et al, sub. 1, p. 1)

The intent of illegal (or 'fraudulent') phoenix activity is to quarantine assets away from liabilities. The new company will typically have the same directors (or controllers) and effectively the same business (including assets) as the old company, but would not be liable for the old company's debt. At the same time, the old company retains its debts and is left as a shell or placed in liquidation. The original company's creditors, including the Australian Taxation Office (ATO), are left to claim against the assetless shell of the old company while the new company continues to trade, free of past liabilities. Box 15.5 describes an example of the methods used in illegal phoenix activity.

Box 15.5 **Structuring illegal phoenix activity**

As identified by the Australian Tax Office, phoenix activity can be structured in a sophisticated manner:

- a closely held private group is set up, consisting of several entities one of which has the role of hiring the labour force for the business;
- the labour hire entity will usually have a single director who is not the ultimate 'controller' of the group;
- the labour hire entity has few, if any, assets and little share capital;
- the labour hire entity fails to meet its liabilities and is placed into administration or liquidation by the ATO;
- a new labour hire entity is set up and the labour moved across to work under this new entity; and
- the process is repeated, with little disruption to the day-to-day operation of the overall business and the financial benefits from the unpaid liabilities are shared amongst the wider group. (The Treasury 2009, p. 2)

The Treasury provided an example that starkly illustrates the number of entities, employees and extent of avoided liabilities that can be involved in phoenix activity:

> A labour hire business with negligible assets and turnover of $30m per annum fragmented its operations across 53 related companies, lodged accurate business activity statements (BAS) for all companies, but failed to remit the required amounts under the PAYG(W) system. The single company director then liquidated every one of these companies within a week, moved his workforce of 2700 into 8 new entities and continued trading. He has since fled Australia. Over $8m in taxes remain unpaid. This labour hire business is still trading and failing to comply with its obligations. (2009, p. 2)

The prevalence and impact of phoenix activity are difficult to determine, but even conservative estimates suggest that it is a significant issue. In terms of the number of phoenix companies, estimates range from between 2000 and 3000 per year[53] to an ATO estimate of a total of 6000 phoenix companies operating in Australia in 2011 (Shorten 2011). The costs of phoenix activity range from nearly $1.8 billion to nearly $3.2 billion per annum (table 15.3).

Table 15.3 **The potential costs of phoenix activity[a]**
$ millions, based on activity in 2009-10

	Lower bound	*Upper Bound*
Costs to employees	191.3	655.2
Costs to business	992.3	1 925.4
Cost to government revenue	600.8	610.6
Total impact	**1 784.3**	**3 191.1**

[a] As modelled by PricewaterhouseCoopers.
Source: Pricewaterhouse Coopers for the Fair Work Ombudsman (2012)

These costs extend to a broad range of parties including unsecured trade creditors, employees, governments, and even competitor businesses:

> Employees may lose their accrued annual and long service leave entitlements, in addition to wages, redundancy and pay in lieu of notice. State and federal taxation authorities lose payroll tax revenue, and pay-as-you-go ('PAYG') instalments and superannuation amounts, deducted from employees' wages, are not remitted. In each case, there can be severe economic repercussions. Trade creditors may experience their own financial crises as a result. Employees are forced to rely on a taxpayer-funded safety net scheme which may not cover all their losses. The government suffers loss and the taxpayer is further burdened where properly levied taxation liabilities are unable to be recovered … Companies that fail to pay taxes, superannuation contributions and employee entitlements can undercut prices in tenders made by law-abiding companies … (Anderson 2012, pp. 412, 414)

Phoenix activity can also have significant impacts in other areas of insolvency. The possibility of illegal phoenix activity is a major driver for investigations of liquidation, and as discussed above could prevent reforms to streamline small liquidations. Phoenix activity that affects employees of the liquidated company will also affect the call on employee assistance schemes such as the FEG. As described in box 15.5, phoenix activity also extends beyond a simple 'liquidate one, start another' approach and can involve

53 This figure is drawn from research undertaken by Dun & Bradstreet which showed that, of the 10 200 companies liquidated in 2009-10, 29 per cent had one more directors previously involved with a liquated entity and 20 per cent had directors who were associated with two more previous liquidations (Ferguson 2010; PwC 2012). Not all directors of previously failed entities will have been engaging in illegal phoenix activity. As such, the lower figure, equating to 2040 liquidated companies, is likely to be a more accurate proxy for phoenix activity.

sophisticated arrangements utilising several entities within a single corporate group. Therefore, in addition to the social costs described above, it is important that insolvency reforms also consider changes to detect and prevent phoenix activity. Without this, any moves towards expediting insolvency could have unintended costs by facilitating phoenix activity. As noted, even accurately defining phoenix activity is difficult due to the element of intent. Overzealous regulation in this sphere runs the risk of creating excessive penalties for those whose wish to start again after a failure that may have been caused by external factors or innocent ineptitude.

There is no shortage of policy and enforcement attention devoted to this issue. For example the Inter-Agency Phoenix Taskforce (established by the pre-existing inter-agency phoenix forum) involves a number of key government agencies, at State and Australian Government level, cooperating to share intelligence, data and legislative ideas to assist in the deterrence of fraudulent phoenix activity (Department of Employment 2015).[54]

As others (Anderson 2012) have noted, penalties in the form of disqualification of directors fines and the compulsory winding up of a company already exist — it is not the law that is lacking in this area, but the enforcement.

The Commission considers that rather than crafting new offences, improvements in the detection and enforcement of existing laws are likely to be the best option for creating a genuine disincentive for directors contemplating phoenix action.

One basic requirement for enforcement is verifying the identity of those involved. While s117 of the Act requires that the application for registration of a company includes the name and address of the directors, little is done to verify this information. As one participant put it during the Commission's consultations 'it is easier to become a company director than it is to rent a movie'. The Commission considers that the adoption of a 'director identity number' (DIN) would enable better tracking of directors of failed companies and prevent the use of fictitious identities. This would ensure that directors of companies that enter external administration can be clearly identified; and would assist in investigations of a director's involvement in what may be repeated unlawful phoenix activity.

Anderson et al (sub. 1, p. 5) highlighted that such a requirement, based on the 'well-accepted and uncontroversial' 100 point identity proof used, for example, when opening bank accounts, would have a relatively low compliance burden but be of significant assistance to a number of regulators:

[54] The member bodies of the taskforce are: Australian Crime Commission, Australian Federal Police, Australian Securities and Investments Commission, Australian Taxation Office (including the Australian Business Register), Clean Energy Regulator, Department of Employment, Department of the Environment, Department of Immigration, Fair Work Building and Construction, Fair Work Ombudsman, ACT Revenue Office, NSW Office of State Revenue, Northern Territory Treasury, Office of the Migration Agents Registration Authority, QLD Office of State Revenue, Revenue South Australia, Tasmanian State Revenue Office, Victorian State Revenue Office, and the WA Office of State Revenue.

> With relatively little inconvenience to honest business operators, a DIN should eliminate the problem of fictitious identities being used for company directorships when new companies are registered. Requiring people to cite their DIN would also assist ASIC in 'joining the dots' between multiple failed companies so that they might seek to have a person with a consistent history of insolvent companies banned from managing any further companies. It would also alert ASIC if disqualified persons attempted to register as directors.
>
> … it would also assist the ATO in data gathering. The regulator's suspicions might be raised when a single person's name is used for the directorships of dozens of companies that the person could not possibly be managing or supervising in compliance with their legal obligations. Anecdotally, we hear that pensioners are sometimes paid a fee to be nominated as a company director, in order to shield a disqualified person. By utilising the DIN, the ATO's extensive database could prompt its phoenix risk team to investigate instances where an elderly person with no assessable income appears to be running one or more companies. The advantages of a DIN are obvious for agencies such as the ACC and the AFP.

The Commission agrees and considers that the benefits of tracking through data matching for regulators should outweigh the relatively low compliance costs for directors. Concerns about privacy can also be overcome in a manner similar to other confidential data held by agencies such as the ATO. To reduce compliance costs, DINS should be available online at the time of an individual's first directorship. As ARITA (2014a, p. 14) suggested, at the same time as applying for a DIN, there would also be value in prospective first-time directors completing a basic 'click through' course to ensure that directors are aware of the duties and responsibilities that come with their positions.

DINs will not be a 'magic bullet' that will eliminate all phoenix activity. Even with director identification and proved offences,[55] sophisticated and legally aware directors may have structured their *personal* affairs in a manner that limits the effectiveness of recovering fines and any incentives for future behaviour. Developments in case law in the *Somerville* case[56] (where a lawyer was found to have breached s79 of the Act by aiding and abetting company directors in their breaches) may provide some disincentive for advisers to assist directors in phoenix activity.

55 Unlike civil penalties for insolvent trading under s588G, the ability to take action against directors for preventing the recovery of employee entitlements (s596AB) are criminal offences, requiring a higher standard of proof.

56 (2009) 77 NSWLR 110.

DRAFT RECOMMENDATION 15.8

Section 117 of the *Corporations Act 2001* (Cth) should be amended to require that, at the time of company registration, that directors must also provide a Director Identity Number (DIN).

A DIN should be obtained from the Australian Securities and Investments Commission (ASIC) via an online form at the time of an individual's first directorship. In order to obtain a DIN individuals should be required to provide 100 points of identity proof, and verify that they have read brief materials on directors' legal responsibilities provided as part of the online registration.

For existing companies, their directors should be required to obtain a DIN. The director DINs should then be provided to ASIC at the annual review date for the company, as a change to company details. To enforce these requirements, ASIC should be empowered under section 205E of the *Corporations Act 2001* (Cth) to ask a person who is a director to provide their DIN.

INFORMATION REQUEST

Given the sophisticated grouping used to undertake phoenix activity, would there be merit in allowing courts to pierce the 'corporate veil' to require that parent (or related) companies pay the debt of insolvent subsidiaries? How complicated would this be to enforce?

What would the relative costs and benefits be of adopting a system similar to that used in New Zealand and Ireland?

Other reforms

The role and funding of the regulator

As noted in relation to phoenix activity, changes in the law can have little impact if they are not implemented, enforced and monitored properly. The Commission is mindful that regulators in this area, particularly ASIC, have the appropriate resources and approaches required to give effect to the necessary reforms.

A key input to effective implementation and monitoring of any policy is quality data (PC 2014a). Structured data that lends itself to examination and analysis can assist regulators and policy makers in identifying the impacts of any changes, trends in activity in the regulated sector and deficiencies in the current law. There is considerable scope to improve insolvency data — some corporate insolvency returns are still in non-electronic readable pdf format that hinders data aggregation:

> … greater disclosure about the circumstances of the company's failure could be required of external administrators. These investigations are already part of the external administrators' duties. At present, the return submitted to ASIC requires a tick-box to indicate that breaches of duty and other civil or criminal offences are suspected. These forms should be amended to allow for comments to be made. In addition, a further tick-box could be inserted so that administrators could report that the breach occurred in a suspected phoenix context. This data would be enormously beneficial for regulators who seek to understand the scope of the problem. (Anderson et al, sub. 1, p. 6)

Current moves to improve ASIC's practices and powers (under the Insolvency Law Reform Bill 2014) in relation to data collection should be allowed to operate before further changes are made.

The Commission has noted in past inquiries the importance of regulators being adequately funded to perform their regulator functions (PC 2013e). The Assetless Administration Fund (the Fund) is a program within ASIC, established in 2006, that finances preliminary investigations and reports by liquidators into the failure of companies with few or no assets, where it appears to ASIC that enforcement action may result from the investigation and report. A particular focus of the Fund is the curbing of illegal phoenix activity (ASIC 2014a). The intention of the Fund is to allow full investigations to occur where they may otherwise have not been attempted due to a lack of funds.

However some have raised issues with the criteria for obtaining funds, and how they are administered. For example, ARITA submitted that its members (insolvency practitioners) 'report that funding may be difficult to obtain and doesn't fully remunerate for the work involved' (sub. 31, p. 30). Anderson (2012, p. 431) also noted a more structural issue with the criteria for access to the Fund:

> … one of the AAF funding criteria is that an initial report must be lodged by a liquidator. The scheme therefore relies on action taken by a liquidator in the first place. Funding, which is capped, is only available for investigations where ... director-banning proceedings may be appropriate, or where court proceedings for serious misconduct … may be warranted. While the *ASIC Regulatory Guide 109* indicates that '[a] particular focus of the AA Fund is to curb fraudulent phoenix activity', it is not available for actions for the recovery of assets, which is the liquidator's primary responsibility. Moreover, funding is only provided if the initial report indicates sufficient evidence exists to support the allegations made. This is surely a 'chicken and egg' argument: access to the fund depends on a liquidator of a company, which by definition is assetless, being willing to make investigations at their own expense to come up with the evidence sufficient to support their application for funding.

The Commission's recommended pool of providers for small liquidations is likely to involve a greater call on the Fund (where there are insufficient funds recovered to pay the liquidator) and require additional funding. In principle, a small levy on the annual review fee for Australian Company Number renewals (but not on new applications) may be an appropriate source. The Commission seeks participants' views on the merits of this suggestion, or other sources for such funding.

INFORMATION REQUEST

The Commission seeks participants' views on changes to the Australian Securities and Investments Commission's (ASIC's) funding, powers and approach that could assist the efficiency of the insolvency process. In particular:

- *In order to facilitate investigation where warranted in 'small' liquidations, should additional funding be provided to the Assetless Administration Fund? What are the relative costs and benefits of using a levy on the annual review fee for Australian Company Number renewals to provide this funding?*
- *Are changes needed to the criteria for accessing the Assetless Administration Fund?*
- *In addition to reforms under the Insolvency Law Reform Bill 2014 (Cth), are there other means to improve ASIC's data collection and utilisation?*

Insolvency of other forms of business

Companies are not the only forms of business that need winding up. While financially distressed sole traders are likely to exit through the bankruptcy regime (chapter 13), the exit process for some other structures is less certain. In particular, ARITA raised the issue of insolvency for trusts, noting that 'Australia's laws do not provide an adequate regime for the winding up of insolvent trading trusts … ' and arguing that '[t]he lack of a comprehensive regime for dealing with insolvent trusts, including managed investment schemes, is a major exit impediment' (sub. 31, pp. 20-1). The Corporations and Markets Advisory Committee (CAMAC) noted that the regulatory regime for managed investment schemes should be aligned with that for companies, unless there are compelling reasons for treating schemes differently (2014b, p. 181). CAMAC also considered that managed investment schemes should be subject to the Corporations Act (or comparable) procedures for schemes of arrangement, voluntary administration and liquidation.

Submissions were due on the discussion paper in June 2014, however the abolition of CAMAC was announced in the 2014-15 Budget, with its functions to be absorbed by the Treasury. The Government's progress on CAMAC's recommendations on managed investment schemes is contingent on its response to the 2014 Financial Systems Inquiry (sub. 20, p. 33).

Given the increasing use of trusts as a form of business (chapter 4) and their tax and legal complexity, the Commission agrees that an efficient system for winding up an insolvent trust is an issue of emerging importance and that there may be merit in aligning the insolvency of trusts with the regime for companies.

INFORMATION REQUEST

Should the process for the insolvency of trusts (and managed investment schemes) be aligned with the approach under the Corporations Act 2001 (Cth)? If so, how should this be implemented?

Are there any unique features of trusts that would prevent the broad adoption of such an insolvency process?

Would this lead to any unintended consequences (such as distortions in choice of business structure) or would it instead address current distortions?

15.5 The Commission's proposed reform framework

The complexity of companies and the Corporations Act, as well as the sophistication of some parties (company directors, lawyers and insolvency practitioners), means that the insolvency system is complex, with many moving parts. Care needs to be taken to ensure that changes in some areas do not cause unintended effects in other aspects of the system.

While the above sections have considered the detail of specific, individual reforms in its approach, the Commission is mindful of how a 'new' insolvency system could fit together.

Allowing options for restructuring at the right time

In moving voluntary administration earlier (by clarifying that it should not be available to insolvent companies) and introducing a safe harbour for directors (subject to protections against abuse), the Commission's reforms aim to improve the effectiveness of restructuring processes. Having an incentive to enter restructuring earlier, when difficulties become apparent rather than when they have become insurmountable, should ensure that a full suite of options for restructure are available to turnaround the company.

Importantly, the Commission envisages that safe harbour will exist alongside the improved voluntary administration process, as well as other existing restructuring options including schemes of arrangement (subject to any changes to streamline their processes) and informal workouts.

These reforms result in a 'menu' of restructuring options, and remove identified impediments to the effective operation of each option. The options vary in their degree of flexibility and formality and the extent of protections available under them. This enables the most informed parties (directors) to choose the option that they feel best suits their circumstances.

Specifically, creating a safe harbour where directors may receive advice but retain control could encourage directors of smaller companies (who are sometimes averse to vesting control in an external party) to seek advice in a formal process rather than attempting to 'tough it out' themselves.

Giving restructuring an opportunity to succeed

Even where a restructuring process is commenced with ample time to 'save' the company, it can still be undermined when important elements of the company are removed. The Commission's proposed changes to the enforcement of ipso facto clauses (subject to protections for suppliers) and the ability of receivers to sell or dispose of assets in a manner that harms the broader company (while still retaining the right to protect the asset and receive any funds from its sale) should act to preserve options for, and thus enhance the effectiveness of, restructuring.

Expediting liquidations, without unintended consequences

The Commission's proposed reforms to create a stream of 'small' liquidations recognises that there is no practical value to an in-depth investigation of a company where very little is at stake and there is no suggestion of criminal activity.

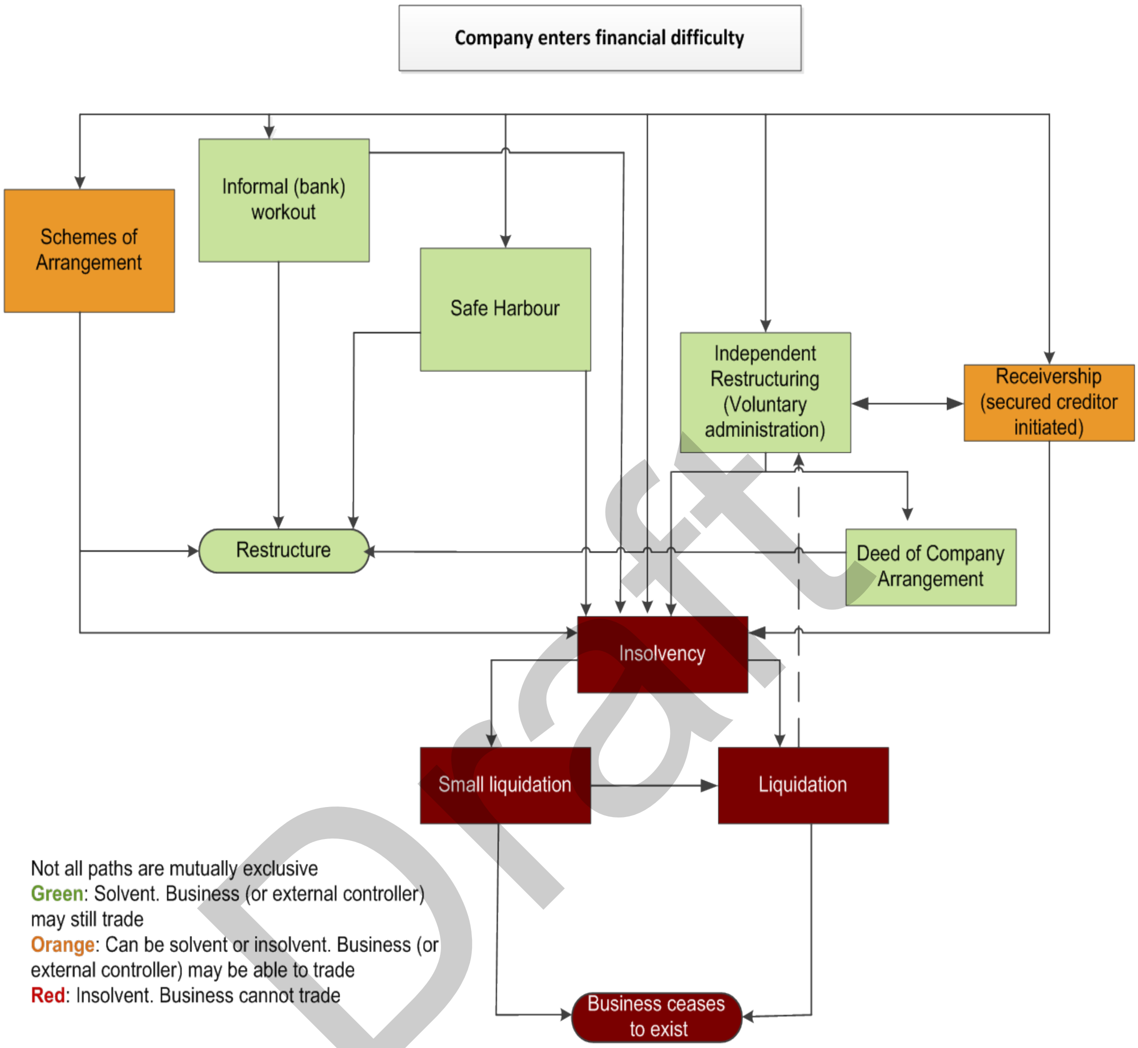
The Commission considers that a risk managed approach therefore justifies a low level of investigation for a small company to be the *default* position. In awareness that expediting such liquidations could facilitate illegal phoenix activity, it has also recommended safeguards.

For small liquidations, the liquidator, creditors or ASIC retain an ability to convert the process to a 'full' liquidation if they believe a full investigation is required. Changes to limit the moral hazard element of employee entitlement assistance schemes and to enable the government to more vigorously pursue its debts as a creditor also improve the accountability of directors and companies that may otherwise escape enforcement. Finally, the introduction of Director Identity Numbers should assist the existing regulatory cooperation in tracking directors involved in phoenix activity.

An integrated system

Figure 15.2 depicts the interactions in the Commission's proposed insolvency framework. The Commission's recommendations have not made direct changes to informal bank workouts, deeds of company arrangement, and liquidations. The change to the overall system arises from the inclusion of new processes (small liquidations and safe harbour) and changes to existing processes — moving the existing voluntary administration process to be earlier, changing the powers of receivers so that receivership better coexists with group insolvency processes and potential reforms to streamline schemes of arrangement.

Figure 15.2 **The Commission's corporate insolvency framework**



A Inquiry conduct and participants

This appendix lists the organisations and individuals that have participated in the inquiry to date. Following receipt of the terms of reference for this inquiry on 20 November 2014, an initial circular advertising the inquiry was distributed to industry organisations and individuals and the inquiry was advertised in national newspapers.

The Commission released an Issues Paper on 19 December 2014 to assist interested stakeholders in preparing their submissions. There were 38 public submissions received by the Commission prior to the release of this draft and they are listed in table A.1.

In addition, the Commission met with a number of businesses, business groups and government agencies. A list of these meetings is in table A.2.

The Commission also held three roundtables with representatives from businesses, industry associations, governments and academics, on the following topics: Access to Finance; Insolvency Arrangements; and New Business Models and the Digital Economy. Participants in these roundtables are listed in table A.3.

Participants are invited to send any additional submissions in response to this draft to the Commission by 3 July 2015. The Commission will provide the final report to the Australian Government by the end of August 2015.

The Commission would like to thank all who have contributed to the inquiry so far.

Table A.1 **Public submissions received**

Participants	*Submission no.*
Ai Group	27
Arnold Bloch Leibler	23
Associate Professor Helen Anderson, Professors Ian Ramsay and Ann O'Connell, Melbourne Law School, and Associate Professor Michelle Welsh, Department of Business Law and Taxation, Monash University	1
Australian Bureau of Statistics	24
Australian Chamber of Commerce and Industry	11
Australian Charities and Not-for-profits Commission	9
Australian Digital Currency Commerce Association	35
Australian Institute of Company Directors	3
Australian Property Institute	2
Australian Restructuring Insolvency & Turnaround Association	31
Australian Securities and Investments Commission	20
Australian Trucking Association	13
BEC Australia	4
Business Council of Australia	29
Chamber of Commerce and Industry Queensland	8
CPA Australia	30
Department of Employment	12
Family Business Australia	38
Future Perspective	17
Google Australia	37
Hosted Accommodation Australia Ltd	22
Institute of Public Accountants	32
Institute of Public Affairs	5
Law Council of Australia	14, 36
Master Builders Australia	33
Master Electricians Australia	6
McGrath Nicol	34
National Australia Bank (NAB)	7
Queensland University of Technology Commercial and Property Law Research Centre	26
Regional Development Australian – NT	16
Restaurant and Catering Australia	21
Shopping Centre Council of Australia	19
Small Business Commissioner	10
Small Business Development Corporation	28
Tasmanian Government	18
The Accommodation Association of Australia	25
Tyro	15

Table A.2 **Consultations**

Participants
Australian Banking Association
Australian Bureau of Statistics
Australian Business Register
Australian Chamber of Commerce and Industry
Australian Competition and Consumer Commission
Australian Digital Currency Commerce Association
Australian Government Attorney General's Department
Australian Government Department of Agriculture
Australian Government Department of Communications
Australian Government Department of Industry
Australian Government Department of the Prime Minister and Cabinet
Australian Government Department of the Treasury
Australian Minerals Exploration Council
Australian Private Equity and Venture Capital Association
Australian Restructuring Insolvency and Turnaround Association
Australian Securities and Investment Commission
Australian Small Business Commissioner
Australian Superannuation Funds Association
Australian Tax Office
Australian Transaction Reports and Analysis Centre
ASX Group
BCR Association
Chamber of Commerce and Industry WA
Charles Maresca – US Small Business Administration Office of Advocacy, Office of Interagency Affairs
Clifford J. White – US Trustee Program
Council of Small Business Australia
CPA Australia
Customer Owned Banking Association
Family Business Organisation
Foreign Investment Review Board
Freelancer
Graeme Samuel – Victorian Taxi Commissioner
Independent Contractors Australia
Indigenous Affairs Group
Indigenous Business Australia
Institute of Public Accountants
Institute of Public Affairs
Law Society of WA
Leon Zwier – Arnold Block Leibler
Michelle Harner – University of Maryland School of Law (United States of America)
Michael Schaper – Curtin University adjunct professor; and ACCC deputy chairman
NSW Small Business Commissioner
Peter Anderson – McGrath Nicol
PriceWaterhouseCoopers
Reserve Bank of Australia
SME Association of Australia
Victorian Department of Economic Development, Jobs, Transport and Resources
Victorian Department of Premier and Cabinet
Victorian Small Business Commissioner
WA Small Business Development Corporation

Table A.3 **Roundtable details and participants**

9 February 2015, Sydney — Access to finance	
Ani Yadav	Reserve Bank of Australia
Ann Quach	NSW Business Chambers
Ellis Connolly	Reserve Bank of Australia
Gary Hobourn	Australian Stock Exchange
John Purcell	CPA Australia
Paul Nielsen	Council of Small Business of Australia
Robyn McMahon	Australian Prudential Regulation Authority
Steven Munchenberg	Australian Bankers' Association
Yasser El-Ansary	Australian Private Equity & Venture Capital Association
9 February 2015, Sydney — Insolvency arrangements	
Adrian Brown	Australian Securities and Investment Commission
Andrew Seaton	Australian Business Lawyers & Advisors (representing NSW Business Chamber and ACCI)
Ian Gilbert	Australian Bankers' Association
Kim Arnold	Australian Restructuring Insolvency and Turnaround Association
Leah Watterson	Australian Institute of Company Directors
Leon Zwier	Arnold Bloch Leibler
Narelle Ferrier	Australian Restructuring Insolvency and Turnaround Association
Paul Nielsen	Council of Small Business of Australia
Peter Anderson	McGrathNicol
Steve Dargavel	Australian Manufacturing Workers' Union
Trevor Clarke	ACTU
19 February 2015, Melbourne — New business models and the digital economy	
Anita Eglitis	egrants.com and Techseeder
Brad Kitschke	Uber
James Holyman	Victorian Taxi Services Commission
Jason Potts	RMIT & Institute of Public Affairs
Jithma Beneragama	Victorian Department of Premier and Cabinet
Jost Stollmann	Tyro payments
Kerri Lee Sinclair	Aconex
Kristina Burke	Victoria Tourism Industry Council
Matt Barrie	Freelancer
Matthew Trigg	Uber
Michael Georgeson	Accommodation Association of Australia
Nick Heys	ACCC
Paul Myers	Victorian Department of Economic Development, Jobs, Transport and Resources
Richard Munro	Accommodation Association of Australia
Sam McDonagh	Airbnb
Samantha Yorke	Google Australia
Sophie Hose	BlueChilli
Stuart Stoyan	MoneyPlace
Thas Nirmalathas	Melbourne Accelerator Program

B Business stock, entry and exit data for Australia and overseas

B.1 Data sources on the number of businesses

There are several sources of data on the number of businesses in Australia and consequently business entries and exits. These sources differ in purpose and by how a business is defined and include:

- the Australian Business Register (ABR)
- Australian Security Investment Commission (ASIC) company register
- Australian Bureau of Statistics (ABS) Counts of Australian Businesses publication, and
- Australia Taxation Office (ATO) taxation statistics.

The ABR collects information on all registered businesses that require an Australian Business Number (ABN). This information is used to identify and validate business entities. Similarly, ASIC manages all corporate entities that are registered for an Australian Company Number (ACN).

The ABS collects business information for its economic surveys. A count of businesses is undertaken for actively trading businesses, defined as those registered for Goods and Services Tax (GST) that have submitted a Business Activity Statement (BAS) in one of the last five quarters (or one of the last three years for annual remitters).

For individuals and entities, the ATO collects reported business income. This data includes not-for-profit businesses and individuals carrying out business activities but not registered for the GST.

Cross-country data is published by the Organisation of Economic Co-operation and Development (OECD).

This appendix is in four parts:

- the measures and characteristics of businesses in Australia
- entries and exits of businesses
- the demographics of business owners, and
- how Australia has performed relative to other countries in regard to business entries and exits.

B.2 Businesses in Australia

The number of businesses in the economy depends on how a business is defined — estimates ranged from 2.1 to 7.7 million at the end of 2013-14. In the broadest sense, businesses can be counted as all entities that are required to be registered or, on a narrower focus, just those businesses that are actively trading goods and services. For the purposes of this inquiry, a business is considered to be an entity (for-profit or not-for-profit) that actively trades goods and services.

The ABR consists of all entities that require an ABN. This includes entities that primarily undertake legal and financial transactions, such as superannuation funds, cash management trusts and property strata, rather than trade in goods and services. Inactive businesses can also remain on the ABR for an extended period of time. Around 25 per cent of ABR (2014b) survey respondents (across all business ownership structures) indicated that they were no longer using their business registration. Reported inactivity was higher for sole traders (41 per cent) and partnerships (35 per cent).

In recent years, the number of entities on the ABR has grown faster than the number of businesses actively trading. This growth has been driven by the increased establishment of investment vehicles, such as superannuation funds, and the occurrence of inactive businesses. Future entity growth on the ABR is expected to be lower, as efforts are underway to remove entities no longer requiring an ABN (ABR 2014a). However, because of the occurrence of inactive businesses and investment vehicles on the ABR, it overstates the number of active businesses.

In contrast, the ABS understates the number of businesses, by only counting for-profit businesses registered for the GST. Businesses operating in the non-market sector, such as charities and sporting clubs, and not-for-profit businesses (even those competing with commercial businesses) are excluded. Changes to data sources and the threshold for GST registration have impacted upon the comparability of these counts of businesses over time.

The Commission estimates that there were just over 2.6 million actively trading businesses at the end of 2013-14. These businesses, irrespective of GST registration or profitability status, contribute to the economy by providing goods and services to consumers and by generating employment and income. There are three components to the Commission's estimate:

- *ABS count of GST registered businesses* — 2.1 million actively trading businesses were registered for GST in 2013-14.
- Non-GST registered businesses — 0.5 million individuals (sole traders and partnerships) reported business income whilst not being registered for GST.[57] While

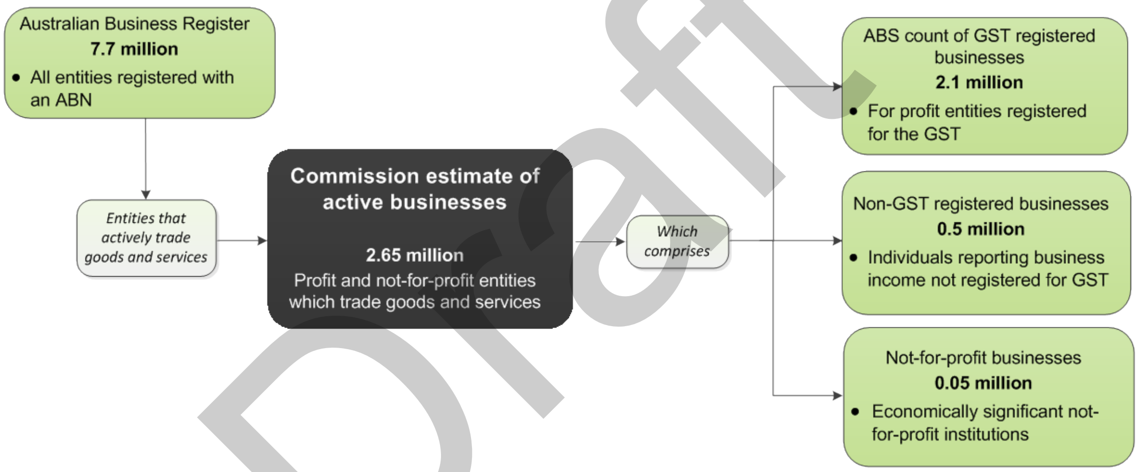
[57] Non-GST registered businesses is for 2012-13 because of a lag in the collection of ATO business income statistics. The number of non-GST registered businesses has been relatively stable, changing by around 1 per cent in the last two years. There are another 0.5 million non-GST registered companies and trusts in operation, based on the industry classification these entities are likely to be investment vehicles.

these businesses generally are small and operate with few intermediate inputs, they operate in the same manner as other businesses and contribute to the economy.

- *Not-for-profit businesses* — 0.05 million economically significant not-for-profit businesses were operating in 2013-14. Many not-for-profit businesses are subject to the same regulatory requirements and standards and operate in the same market as commercial businesses. To consumers, not-for-profit businesses are largely indistinguishable from commercial businesses.

Figure B.1 presents the ways that businesses are counted in Australia, indicating the components of the Commission's estimate.

Figure B.1 **Businesses in Australia[a]**
2013-14



[a] Businesses at the end of 2013-14. Count of non-GST registered businesses is for 2012-13.
Source: ABR (2014a); ABS (2015c); ASIC (2014b) and ATO taxation statistics

Number of businesses by industry

The number of businesses varies according to the industries in which they operate and generally reflects economies of scale and higher fixed costs required to set-up and enter some industries. For example, industries with higher fixed capital cost requirements, such as mining and electricity, have fewer actively trading businesses than those industries, such as construction and retail, which have lower fixed capital costs (table B.1).

The incidence of non-GST and not-for-profit businesses also differs between industries. Non-GST businesses are more common in personal labour service industries, such as information, media and telecommunications and education. Not-for-profit businesses are more common in industries that primarily involve the provision of welfare and social services, such as public administration and health care. Those businesses registered for GST account for the majority of businesses in primary industries, such as agriculture and mining.

Table B.1 **Commission's estimate of businesses, by industry[a]**
2013-14

Industry	*Commission estimate*	*ABS count of businesses*	*Non-GST businesses*	*Not-for-profit businesses[b]*
	'000	Per cent (of industry total)	Per cent (of industry total)	Per cent (of industry total)
Agriculture	206.3	89.1	10.7	0.2
Mining	8.8	93.6	6.3	0.1
Manufacturing	103.2	81.2	18.7	0.1
Electricity	6.9	86.1	12.1	1.8
Construction	400.8	84.4	15.6	0.1
Wholesale Trade	80.8	94.5	5.4	0.2
Retail Trade	160.0	84.1	15.5	0.4
Accommodation	95.8	89.0	7.0	1.0
Transport	138.5	91.4	8.4	0.2
Information Media and Telecoms	31.1	61.4	36.8	1.8
Finance	191.8	91.1	8.1	0.8
Rental and Real Estate Services	240.0	95.6	4.0	0.4
Professional Services	327.5	75.6	23.0	0.5
Administrative and Support Services	135.4	85.3	40.8	0.9
Public Administration and Safety	10.2	67.7	21.5	10.9
Education	61.1	43.2	47.4	9.3
Health Care	161.1	70.3	25.3	4.4
Arts and Recreational Services	76.9	34.0	58.4	7.7
Other Services	159.3	55.2	21.4	13.4
Unknown	60.9	72.4	25.7	1.9
All industries	**2 656.9**	**79.0**	**18.9**	**2.0**

[a] Businesses at the end of 2013-14. Count of non-GST registered businesses is for 2012-13. [b] Some not-for-profit businesses in the 'other services' industry may not trade goods and services (accounting for fewer than 0.3 per cent of all businesses). Differences between total and components are due to rounding.

Source: ABR (2014b); ABS (2015c) and ATO taxation statistics

Non-GST registered businesses are small

The majority of non-GST registered businesses (individuals and partnerships) operate with no employees (99 per cent). Those with employees are expected to be small, as most non-GST registered businesses had turnover below $50 000 (88 per cent) and despite the $75 000 threshold for GST registration, around 1 per cent had turnover greater than $200 000 (ATO taxation statistics, unpublished).

Not-for-profit businesses are larger and most operate as companies

Not-for-profit businesses are larger on average than for-profit businesses and are a substantial employer — estimates suggest over 1 million people were employed by a not-for-profit businesses in 2012-13 (ABS 2014c). Around one-third of not-for-profit businesses had turnover below $50 000 in 2013-14 and only one in ten had turnover greater than $2 million. Most not-for-profit businesses operate as companies (95 per cent) and are more likely to do so at higher turnover levels.

A small group are innovative

Few business are innovative in terms of delivering a new product, process or marketing approach to an Australian or international market. It is estimated that 1.6 per cent of all businesses introduced a product or service that was new to the world in 2012-13, while a further 1.1 per cent introduced a product or service that was new to Australia. A smaller share of businesses introduced an operational process (0.7 per cent) or marketing approach (0.3 per cent) that was new to the world.[58]

Innovation requiring intellectual property protection was less common. Resident patent applications accounted for around 0.1 per cent of actively trading businesses in 2012-13, a smaller proportion (0.04 per cent) were granted patents. Similarly, start-ups in the 'high tech' industries represent a very small proportion (0.05 per cent) of the broader business population.

Large businesses are more likely than small businesses to innovate. In 2012-13, around 6 per cent of large businesses introduced a product or service that was new to the world, compared with 1 per cent of small businesses. The difference in innovation rates between large (14 per cent) and small businesses (1 per cent) was greater for the introduction of products and services that were new to Australia.

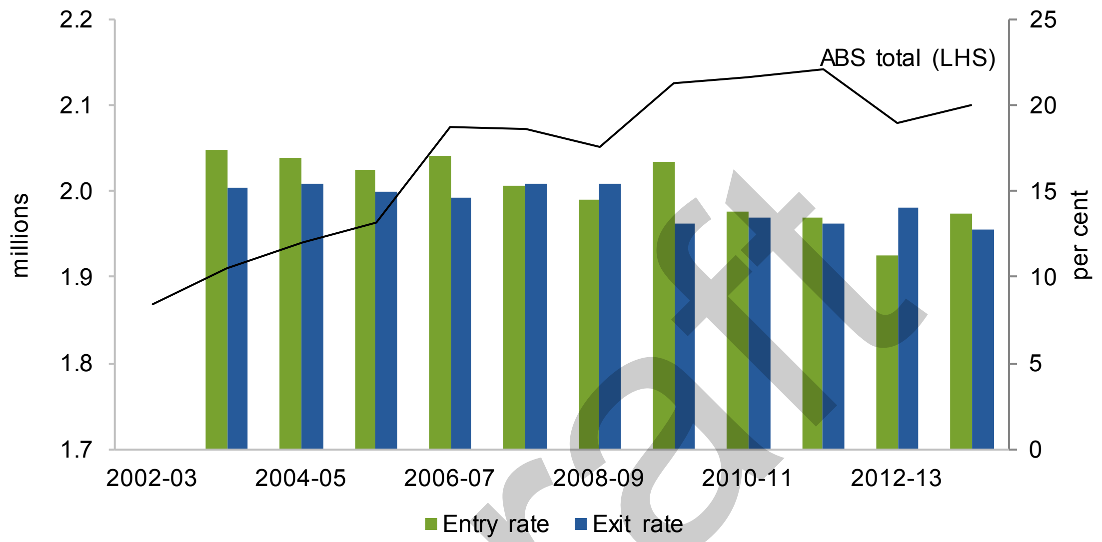
B.3 Business entry and exit trends

Due to data limitations, business entry and exit rates are based on GST-registered for-profit businesses (as published by the ABS). In recent years, there has been little variation in the number of not-for-profit and non-GST registered businesses (around 1-3 per cent a year). Given this, the ABS measure is considered to be broadly indicative of business entry and exit trends. This discrepancy may be larger in specific industries, such as construction and education, where non-GST registered and not-for-profit businesses are more common.

58 Rates of innovation are based on ABS (2014e) innovation estimates for employing businesses, non-employing businesses are assumed to innovate at the rate observed by Soames et al. (2011, p. 45) for sole traders (individuals). Proportions are relative to the Commission's estimate of the number of actively trading businesses.

The number of businesses in Australia has generally increased over the last decade. Business numbers declined around the global financial crisis (GFC), subsequently peaked in 2011-12 before declining again in the following year. While the number of businesses has increased, entries and exits have declined in absolute terms and as a proportion of all businesses over this period (figure B.2).

Figure B.2 **Businesses and the rate of entry and exit in Australia[a]**



[a] Entry and exit rates are calculated as a percentage of businesses at the beginning of the financial year. A small number of businesses within scope of the ABS publication enter after 30 June in a given year and exit before 30 June in the following year. This time series draws on a number of ABS publications, each of which have different methodologies. The GST threshold was increased in 2007-08, this may have influenced the rate of entry and exit.

Source: ABS (2007, 2012, 2015c)

Generally, comparisons of entries and exits are made as a proportion of all businesses. In line with the ABS, three measures of business set-up, transfer and closure are used in this inquiry.

- *Entry rate* — flows in, following set-up or the transfer of ownership, as a proportion of all businesses.
- *Exit rate* — flows out, following closure or the transfer of ownership, as a proportion of all businesses.
- *Survival rate* — the proportion of businesses that are still actively trading after a period of time. Survival rates provide another indication of the rate of exit for a group of businesses, usually those set-up over a 12 month period or all businesses actively trading at a point in time.

Businesses can be characterised in a range of ways. The prevalence of businesses and the rate of entry and exit varies by size (employment and turnover), industry, location and legal structure.

There are some characteristics of businesses that tend to indicate higher entry and exit rates. In summary, between 2009-10 and 2013-14, the majority of entries and exits were small businesses, with fewer than 20 employees or turnover below $50 000. At set-up, company structures are becoming more common and the number of health care and finance businesses has grown strongly. Over the same period, businesses closing were typically operating as a sole trader. The highest rates of entry have been in Western Australia and the territories. The rate of closure was higher in Queensland, Western Australia and the territories, and in industries such as public administration and support services.

Entry and exit by business size

There are a range of indicators, such as turnover, the number of employees, loan size or asset base, that can be used to determine the size of a business. Entries and exits are published by the ABS for two business size indicators — the number of employees and turnover.

By the number of employees

The majority of businesses in Australia are small. Over 97 per cent had fewer than 20 employees and over half were non-employing businesses at the end of 2013-14. The decline in business numbers between 2009-10 and 2013-14 was driven by a decrease in the number of non-employing and micro businesses with fewer than four employees (table B.2).

Non-employing businesses accounted for over 70 per cent of all entries and exits. These businesses had the highest average rate of entry (14.3 per cent) and exit (16.4 per cent) between 2009-10 and 2013-14. The rate of entry and exit generally declines as the number of people employed by the business increases. The largest businesses, those with more than 200 employees, had the lowest rate of entry, while their rate of exit was slightly higher than medium businesses over the same period.

Table B.2 **Businesses and entry and exit rates, by number of employees**[a]

2009-10 to 2013-14

Employee size	*Number of employees*	*End of 2009-10*	*End of 2013-14*	*Average entries*	*Average entry rate*	*Average exits*	*Average exit rate*
		'000	'000	'000	per cent	'000	per cent
Small	0-19	2 072.2	2 044.9	275.8	13.3	280.3	13.6
of which:	0	1 303.0	1 273.8	185.4	14.3	213.8	16.5
	1-4	580.2	571.2	80.9	13.9	55.5	9.6
	5-19	189.0	199.9	9.4	4.9	10.9	5.6
Medium	20-199	49.0	51.7	1.4	2.8	2.0	4.0
Large	200+	3.5	3.6	0.1	2.8	0.2	4.4
Total[b]		**2 132.4**	**2 100.2**	**276.3**	**13.1**	**282.4**	**13.3**

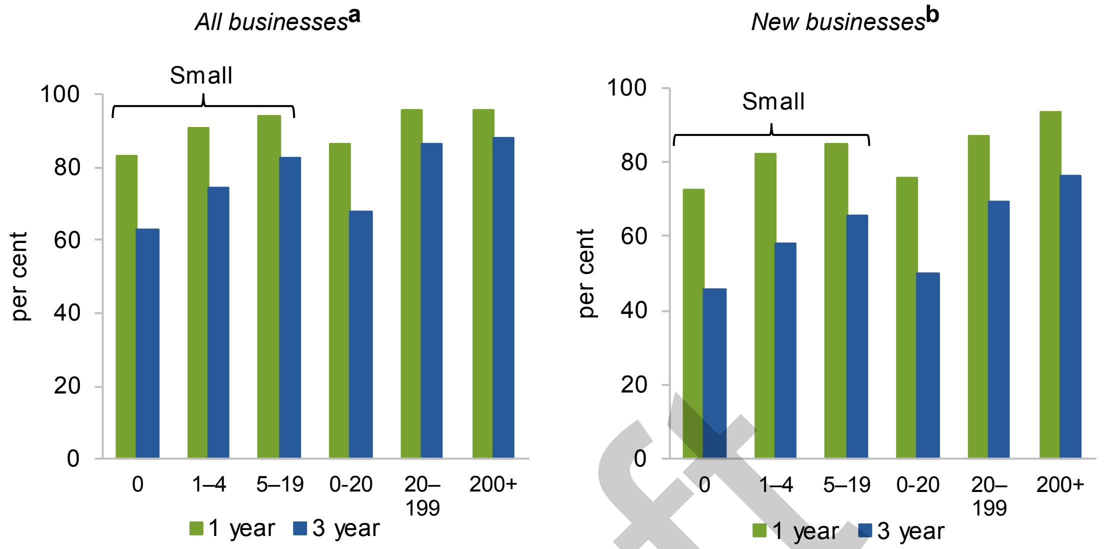
[a] Averages are the arithmetic mean of the four financial years. Entry and exit rates as a proportion of businesses in each size category at the beginning of the financial year. Differences between total and components are due to rounding. [b] Totals refer to GST-registered for-profit businesses only.

Source: ABS (2015c)

Business survival increases as the number of employees increases. Non-employing businesses had the lowest rate of survival, around 60 per cent of those operating at the beginning of 2010-11 were still active after three years. Over the same period, nearly 75 per cent of businesses with 1-4 employees were still active. Survival rates for businesses with 5-19 employees were more similar to medium and large business survival rates than smaller businesses (figure B.3).

New businesses have lower rates of survival. Of the businesses set-up in 2010-11, under half of those with no employees were still operating after three years. The chances of new business survival increased with the number of employees with around 76 per cent of new businesses with more than 200 employees having survived over the period.

Figure B.3 **Business survival rates, by number of employees**
2010-11 and 2013-14



[a] All businesses that were operating at the end of 2009-10. [b] All businesses that were set-up or recommenced trading in 2010-11.

Source: ABS (2015c)

By turnover

Over half of all actively trading businesses had turnover below $200 000, around three in ten had turnover between $200 000 and $2 million and fewer than one in ten had turnover greater than $2 million. Between 2009-10 and 2013-14, the number of businesses with turnover below $200 000 declined, while the number business with turnover greater than $200 000 increased and grew most strongly for those with turnover over $2 million (table B.3).

Businesses with turnover between $50 000 and $200 000 had the highest rate of entry between 2009-10 and 2013-14. As turnover exceeded $200 000, the rate of entry declined and for the largest businesses was around a quarter the rate of entry by the smallest businesses.

On average, the rate of exit declines as business turnover increases. Between 2009-10 and 2013-14, the average exit rate for businesses with turnover greater than $2 million was around a fifth the rate of exit for businesses with turnover below $50 000. Reflecting the change in business numbers over the period, the rate of entry for businesses with turnover between $50 000 and $2 million exceeded the rate of exit, while exit rates exceeded entry rates for businesses with turnover below $50 000.

Table B.3 **Businesses and entry and exit rates, by turnover**[a]

2009-10 to 2013-14

Turnover	*End of 2009-10*	*End of 2013-14*	*Annual growth*	*Average entries*	*Average entry rate*	*Average exits*	*Average exit rate*
	'000	'000	% / year	'000	per cent	'000	per cent
Zero to less than $50K	627	556	-3.0	82.3	13.7	125.0	20.9
50K to less than $200K	740	723	-0.6	121.7	16.6	101.5	13.9
200K to less than $2m	637	687	1.9	67.5	10.3	50.8	7.7
$2m or more	121	135	2.8	4.7	3.7	5.1	4.0
Total[b]	**2 125**	**2 100**	**-0.3**	**276.3**	**13.1**	**282.4**	**13.3**

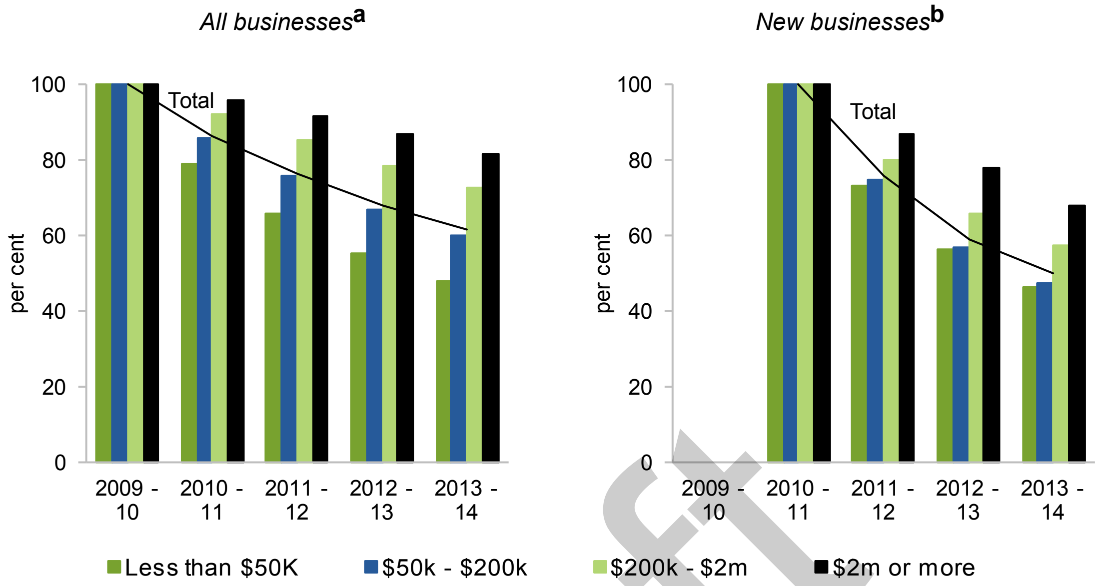
[a] Averages are the arithmetic mean of the four financial years. Entry and exit rates as a proportion of businesses in each size category at the beginning of the financial year. Differences between total and components are due to rounding. [b] Totals refer to GST-registered for-profit businesses only.

Source: ABS (2015c)

Business survival increases with turnover. Under half of all businesses with turnover below $50 000 in 2009-10 continued to be in operation after four years. The rate of survival increased with business size and around 82 per cent of businesses with turnover greater than $2 million were still in operation over the same period (figure B.4).

New businesses have lower rates of survival. Approximately 47 per cent of established businesses in 2010-11 with turnover below $200 000 were in operation after three years. The prospect of new business survival increases for those with higher turnover. Over the same period, around 68 per cent of set-ups with turnover greater than $2 million were still in operation compared to 46 per cent of businesses with turnover below $50 000.

Figure B.4 **Business survival rates, by turnover**



[a] All businesses that were operating at the end of 2009-10. [b] All businesses that were set-up or recommenced trading in 2010-11.

Source: ABS (2015c)

Entry and exit rates by industry

The number of businesses varies across industries. In 2013-14, construction had the most businesses and electricity the least. Business numbers between 2009-10 and 2013-14 have grown strongly in service industries, particularly in health care and finance. The largest declines in business numbers were in agriculture and manufacturing (table B.4).

Between 2010-11 and 2013-14, average entry rates were the highest in the accommodation and administrative services industries. Entry rates were substantially lower in agriculture and around half the entry rate for all businesses. Manufacturing and rental and real estate services also had relatively low rates of entry.

Public administration and administrative support industries had the highest rates of exit between 2010-11 and 2013-14, while health care and rental hiring had lower exit rates. Reflecting the change in business numbers over the period, the rate of entry in health care and finance exceeded the rate of exit, while exits were greater than entries in agriculture and manufacturing.

Table B.4 **Businesses and entry and exit rates, by industry**[a]

2009-10 to 2013-14

Industry	*End of 2009-10*	*End of 2013-14*	*Annual growth*	*Average entries*	*Average entry rate*	*Average exits*	*Average exit rate*
	'000	'000	% / year	'000	%	'000	%
Agriculture	204.2	183.8	-2.6	13.5	6.9	18.7	9.6
Mining	7.9	8.3	1.3	1.0	12.7	0.9	11.4
Manufacturing	91.8	83.8	-2.2	8.5	9.5	10.5	11.7
Electricity	5.7	5.9	0.8	0.8	14.2	0.8	13.3
Construction	351.5	338.2	-1.0	49.3	14.2	52.6	15.1
Wholesale Trade	79.2	76.4	-0.9	9.4	11.9	10.1	12.8
Retail Trade	143.9	134.5	-1.7	18.4	13.0	20.8	14.6
Accommodation	80.3	85.3	1.5	14.3	17.5	13.1	16.0
Transport	135.4	126.6	-1.7	17.4	13.3	19.6	14.9
Information Media and Telecoms	18.7	19.1	0.5	3.0	15.7	2.9	15.2
Finance	161.1	174.7	2.1	21.6	13.1	18.2	11.0
Rental and Real Estate Services	225.6	229.3	0.4	21.9	9.6	20.9	9.2
Professional Services	247.7	250.6	0.3	34.5	13.8	33.8	13.5
Administrative and Support Services	81.6	78.9	-0.8	13.3	16.3	13.9	17.1
Public Administration and Safety	7.8	7.3	-1.7	1.2	15.7	1.3	17.4
Education	25.9	26.4	0.5	3.8	14.4	3.7	13.9
Health Care	98.1	113.2	3.7	12.2	11.9	8.4	8.2
Arts and Rec Services	28.0	26.1	-1.7	3.6	13.4	4.1	15.0
Other Services	89.2	87.9	-0.4	12.0	13.4	12.3	13.8
Unknown	41.1	44.1					
All industries[b]	**2 124.7**	**2 100.1**	**-0.3**	**276.3**	**13.1**	**282.4**	**13.3**

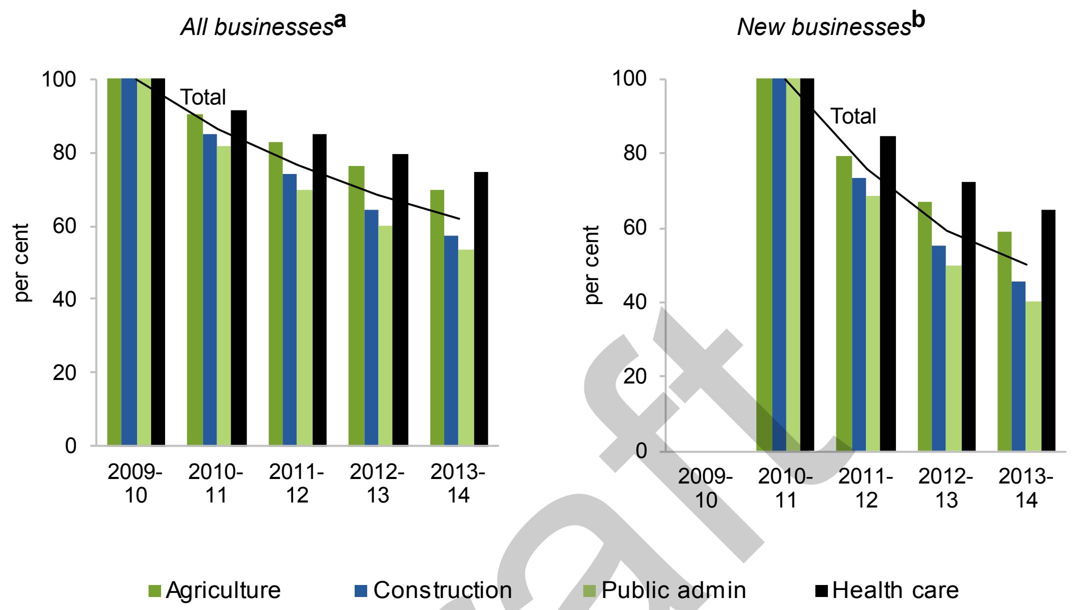
[a] Averages are the arithmetic mean of the four financial years. Entry and exit rates as a proportion of businesses in each industry at the beginning of the financial year. Differences between total and components are due to rounding. Unknown refers to businesses that are yet to be coded to an industry by the ABS. [b] All industry totals refer to GST-registered for-profit businesses only.

Source: ABS (2015c)

Survival rates differ between industries. Businesses in the health care industry had the highest survival rates — around 74 per cent operating in 2009-10 were still operating after four years. Industries such as construction and public administration had lower rates of survival with just over half of all businesses in these industries having survived over the same period (figure B.5).

New businesses established in the health care industry had the greatest prospect of survival. Around 65 per cent of businesses set-up in health care in 2010-11 were still operating after 3 years. This compares with businesses in public administration and construction, where fewer than half of set-ups survived over same period. While business numbers have been declining in agriculture, new businesses in the industry have a greater prospect of survival than the average set-up after three years.

Figure B.5 **Business survival rates, for selected industries**



[a] All businesses that were operating at the end of 2009-10. [b] All businesses that were set-up or recommenced trading in 2010-11.

Source: ABS (2015c)

By location

The number of businesses operating in each state and territory generally reflects its population size. At the end of 2013-14, the most businesses were in New South Wales (NSW) while the Northern Territory had the least. In contrast to the national decline in actively trading businesses between 2009-10 and 2013-14, business numbers grew strongly in Victoria followed by the ACT. The largest proportional declines in business numbers were in Tasmania and Queensland (table B.5).

Table B.5 **Businesses, by main state**[a]

2009-10 to 2013-14

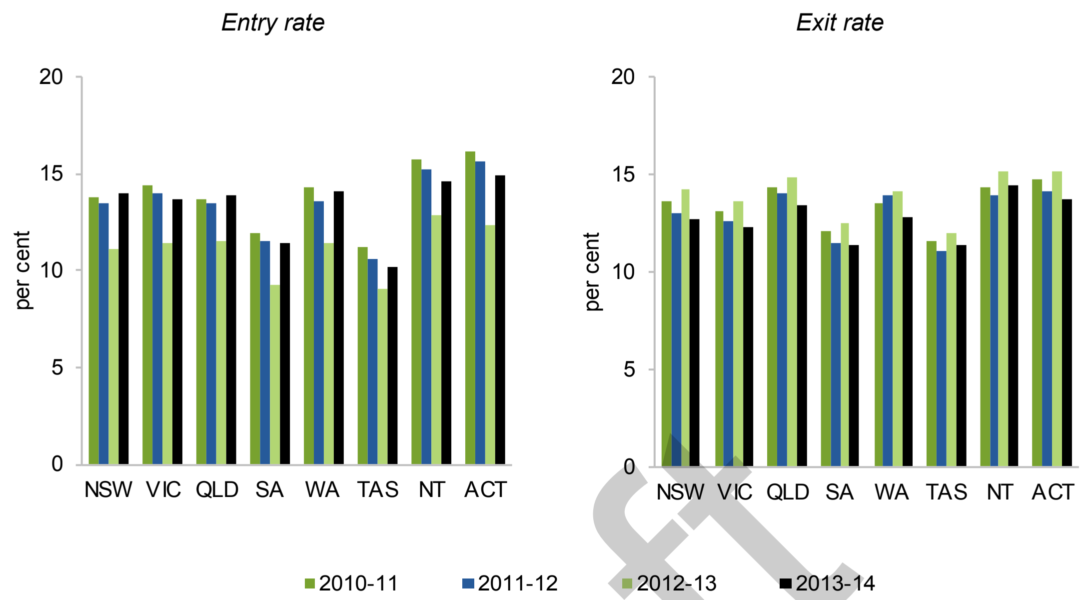
State	*End of 2009-10*		*End of 2013-14*		*Annual growth*
	'000	per capita	'000	per capita	% / year
New South Wales	704.8	9.9	697.0	9.3	-0.3
Victoria	537.3	9.8	546.0	9.3	0.4
Queensland	433.4	9.8	416.7	8.8	-1.0
South Australia	148.7	9.1	143.6	8.5	-0.9
Western Australia	220.9	9.6	218.8	8.5	-0.2
Tasmania	39.0	7.7	37.0	7.2	-1.3
Northern Territory	14.2	6.2	14.3	5.8	0.2
Australian Capital Territory	25.2	7.0	25.5	6.6	0.3
Unknown	1.3		1.4		
Australia[b]	**2 125**	**9.6**	**2 100**	**8.9**	**-0.3**

[a] Main state refers to the state in which the business undertakes the majority of its activity. Per capita estimates are the number of actively trading businesses per 100 people at the end of financial year. [b] Totals refer to GST-registered for-profit businesses only.

Source: ABS (2014a, 2015c)

The states and territories have shown similar entry and exit trends. The rate of entry peaked across all jurisdictions in 2010-11, while the exit rate peaked in 2012-13. However, there are differences in the average entry and exit rates between jurisdictions. Those jurisdictions with highest rates of entry, Northern Territory and ACT, also had the highest exit rates between 2010-11 and 2013-14. Similarly, Tasmania and South Australia had the lowest entry and exit rates over the same period (figure B.6).

Figure B.6 **Business entry and exit rates, by main state[a]**



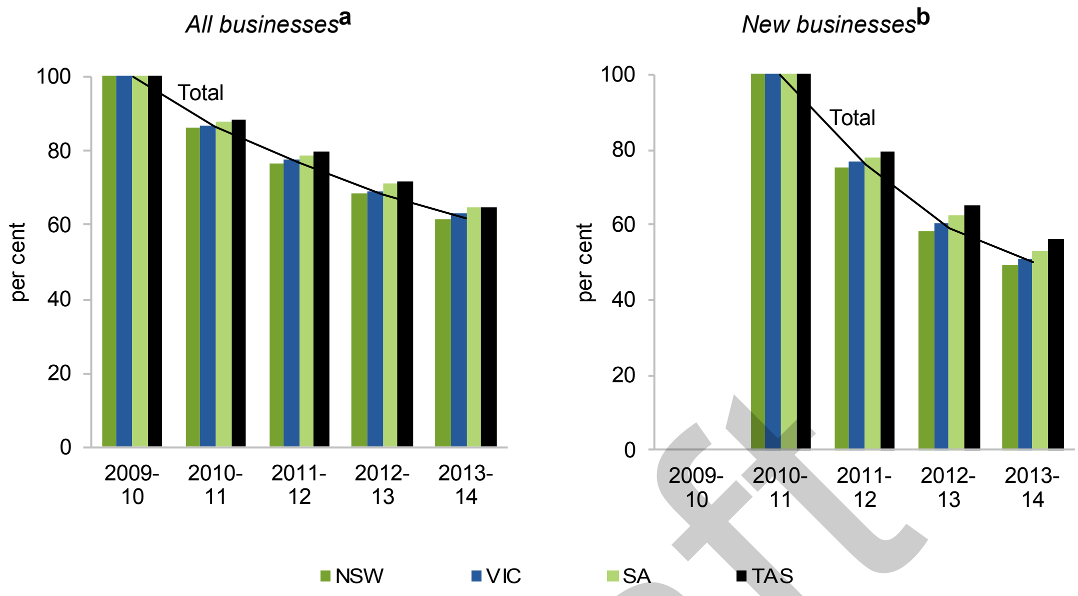
[a] Entry and exit rates as a proportion of businesses in each state at the beginning of the financial year.

Source: ABS (2015c)

Business survival rates differ across the states and territories. Those businesses operating in South Australia and Tasmania had the highest rates of survival between 2009-10 and 2013-14, while those in NSW and Victoria had slightly lower chances of survival (figure B.7).

There is greater variation in survival rates for new businesses across the states and territories. Businesses set-up during 2010-11 had the highest rates of survival after three years in Tasmania (56 per cent) and South Australia (53 per cent) and around half of all businesses survived after three years in NSW and Victoria. The chances of a new business surviving were lowest in Queensland — where around 48 per cent of new businesses survived over the same period.

Figure B.7 **Business survival rates, for selected states**
2009-10 to 2013-14



[a] All businesses that were operating at the end of 2009-10. [b] All businesses that were set-up or recommenced trading in 2010-11.

Source: ABS (2015c)

By business structure

Companies account for around 36 per cent of actively trading businesses, followed by sole traders (26 per cent), trusts (24 per cent) and partnerships (14 per cent). The number of businesses being operated through trusts and companies increased between 2009-10 and 2013-14, while partnerships and sole traders declined over the period (table B.6).

The majority of entries between 2009-10 and 2013-14 were by companies, while a larger share of exits were by sole traders. As a proportion of each entity type, there has been greater entry by sole traders and companies, while partnerships had a relatively low rate of entry.

The rate of exit between 2009-10 and 2013-14 was highest for the least complex business structures (sole traders), followed by partnerships and companies. Trusts had substantially lower rates of exit. Reflecting the change in business numbers over the period, the rate of entry for companies and trusts exceeded the rate of exit.

Table B.6 **Businesses and entry and exit rates, by business structure[a]**
2009-10 to 2013-14

	End of 2009-10	*End of 2013-14*	*Annual growth*	*Average entries*	*Average entry rate*	*Average exits*	*Average exit rate*
	'000	'000	% / year	'000	per cent	'000	per cent
Sole traders	635.0	555.3	-3.3	94.0	15.5	114.0	18.8
Partnerships	354.3	299.5	-4.1	26.0	7.8	39.7	11.9
Companies	688.7	747.6	2.1	98.0	13.8	83.3	11.7
Trusts	446.0	497.2	2.8	58.2	12.5	45.4	9.7
Total[b]	**2 124.7**	**2 100.2**	**-0.3**	**276.3**	**13.1**	**282.4**	**13.3**

[a] Averages are the arithmetic mean of the four financial years. Entry and exit rates as a proportion of businesses in each industry at the beginning of the financial year. Differences between total and components are due to rounding. Excludes public sector businesses, which are a small share (0.03 per cent) of all businesses. [b] Totals refer to GST-registered for-profit businesses only.

Source: ABS (2015c)

Business structures vary by industry and state

In 2013-14, company structures were more common in capital intensive industries, such as mining, manufacturing and electricity. Sole traders were more common in service industries, such as health care, transport and construction. Almost half of all businesses in agriculture operate through a partnership (48 per cent), operating as a sole trader (29 per cent) is the second most common structure followed by trusts (14 per cent) and companies (9 per cent). While trust structures are fairly uncommon in most industries, they do form the majority of businesses in finance and rental and real estate services (table B.7).

Table B.7 **Count of businesses, by structure and industry**[a]
2013-14

Industry	*Sole traders*	*Partnerships*	*Companies*	*Trusts*	*Total*[b]
	'000	'000	'000	'000	'000
Agriculture	53.1	88.3	16.6	25.7	183.8
Mining	0.8	0.4	6.3	0.8	8.3
Manufacturing	16.2	9.9	42.8	14.9	83.8
Electricity	0.9	0.6	3.1	1.2	5.9
Construction	111.5	45.4	121.1	60.2	338.2
Wholesale Trade	8.9	6.1	48.6	12.7	76.3
Retail Trade	28.5	22.5	55.0	28.4	134.5
Accommodation	12.6	15.6	34.9	22.1	85.3
Transport	60.4	12.1	39.6	14.4	126.6
Information Media and Telecoms	4.0	1.1	11.8	2.1	19.1
Finance	8.7	2.6	44.0	119.3	174.7
Rental and Real Estate Services	29.5	48.3	64.0	87.5	229.3
Professional Services	76.2	12.5	119.6	42.2	250.6
Administrative and Support Services	24.2	8.6	32.4	13.7	78.9
Public Administration and Safety	2.1	0.4	3.9	0.9	7.3
Education	7.9	1.7	13.5	3.4	26.4
Health Care	56.4	3.8	34.2	18.8	113.2
Arts and Rec Services	12.3	2.6	8.1	3.1	26.1
Other Services	31.5	13.5	28.3	14.6	87.9
Unknown					44.1
All industries	**575.7**	**296.2**	**727.6**	**486.1**	**2 100.2**

[a] Counts of businesses for the end of 2013-14. Excludes public sector businesses. Unknown refers to businesses that are yet to be coded to an industry by the ABS. [b] Totals refer to GST-registered for-profit businesses only.

Source: ABS (2015c, unpublished)

The share of entity types in each state and territory differs according to the nature of economic activity. Of the businesses operating in 2013-14, trusts were more common in South Australia, Western Australia and Victoria and less common in New South Wales. Company structures were most common in New South Wales and the ACT, while sole traders were common in the Northern Territory and Tasmania (table B.8).

Table B.8 **Count of businesses, by structure and main state[a]**
2013-14

State	*Sole traders*	*Partnerships*	*Companies*	*Trusts*	*Total[b]*
	'000	'000	'000	'000	'000
New South Wales	191.9	98.8	299.3	106.8	696.9
Victoria	142.4	66.0	182.0	155.4	545.9
Queensland	104.1	62.6	138.3	111.6	416.7
South Australia	37.9	25.7	35.8	44.0	143.6
Western Australia	56.3	34.3	64.9	63.2	218.8
Tasmania	11.3	7.7	9.8	8.3	37.0
Northern Territory	4.5	1.6	5.5	2.6	14.3
ACT	6.6	2.7	11.0	5.3	25.5
Unknown					1.4
Australia	**55.0**	**299.5**	**746.5**	**497.2**	**2 100.2**

[a] Counts of businesses for the end of 2013-14. Main state refers to the state in which the business undertakes the majority of its activity. Excludes public sector businesses and unknown refers to entities with no locational information. [b] Totals refer to GST-registered for-profit businesses only.

Source: ABS (2015c, unpublished)

The largest businesses are companies

Small businesses with fewer than 20 employees are common across all business structures. Over 99 per cent of sole traders and partnerships were small in 2013-14 compared with 97 per cent of trusts and 95 per cent of companies. The largest businesses, those with more than 200 employees, generally operate as companies (87.7 per cent) or trusts (10.1 per cent), and few large businesses are formed as partnerships or sole traders (table B.9).

For all business structures, the average rate of entry and exit between 2009-10 and 2013-14 declined as the number of employees increases. For small businesses over the same period, sole traders had the highest entry and exit rates, while partnerships had the lowest entry rate and trusts had the lowest exit rates. Large companies had higher rates of entry and exit compared with large trusts.

Table B.9 **Businesses and entry and exit rates, by business structure and number of employees**[a]

2009-10 to 2013-14

Structure	*Number of employees*	*End of 2009-10*	*End of 2013-14*	*Average entries*	*Average entry rate*[b]	*Average exits*	*Average exit rate*[b]
		'000	'000	'000	per cent	'000	per cent
Sole traders							
	0-19	634.4	554.7	94.0	15.5	113.9	18.7
	20-199	0.7	0.6	0.0	4.8	0.1	11.1
	200+	0.0	0.0	0.0	-	0.0	-
	Total	635.0	555.3	94.0	15.5	114.0	18.8
Partnerships							
	0-19	351.3	269.6	25.9	7.8	39.4	11.9
	20-199	3.0	2.8	0.1	2.7	0.2	7.8
	200+	0.1	0.1	0.0	-	0.0	-
	Total	354.3	299.5	26.0	7.8	39.7	11.9
Companies							
	0-19	652.2	708.7	96.9	14.4	81.9	12.2
	20-199	33.5	35.8	1.0	3.1	1.2	3.6
	200+	3.0	3.1	0.1	2.8	0.1	4.1
	Total	688.7	747.6	98.0	13.8	83.3	11.7
Trusts							
	0-19	434.0	484.6	58.0	12.7	44.9	9.9
	20-199	11.7	12.3	0.2	2.1	0.5	3.8
	200+	0.3	0.4	0.0	1.3	0.0	4.0
	Total	446.0	497.2	58.2	12.5	45.4	9.7
Economy total[c]		**2 124.7**	**2 100.2**	**276.3**	**13.1**	**282.4**	**13.3**

[a] Averages are the arithmetic mean of the four financial years. Entry and exit rates as a proportion of businesses in each size category at the beginning of the financial year. Differences between total and components are due to rounding. [b] Average entry and exit rates are not provided for categories with fewer than 100 businesses and is denoted by '-'. [c] Totals refer to GST-registered for-profit businesses only.

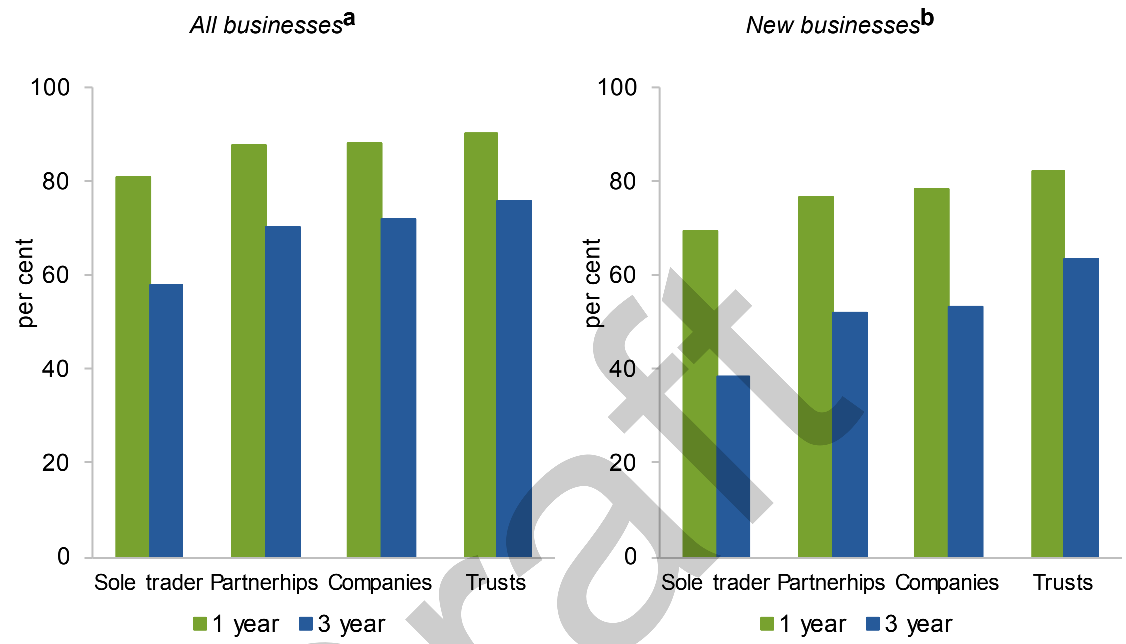
Source: ABS (2015c, unpublished)

Business survival increases with the complexity of the structure

Like the rate of exit, the likelihood of survival increases with the complexity of the business structure. Trusts had the highest rate of survival, around 75 per cent of those operating at the beginning of 2010-11 were still active after three years. Over the same period, similar rates of survival were observed for companies and trusts, while sole traders had lower survival rates (57 per cent) (figure B.8).

Although fewer new businesses survive after one or three years, similar survival trends by business structure are observed. New businesses formed as trusts had the highest rates of survival, over 82 per cent of those established in 2010-11 were still operating after one year, while 63 per cent were operating after three years. New sole traders had the lowest rate of survival with only 38 per cent still operating after three years.

Figure B.8 **Business survival rates, by business structure**
2010-11 and 2013-14



[a] All businesses that were operating at the end of 2009-10. [b] All businesses that were set-up or recommenced trading in 2010-11.

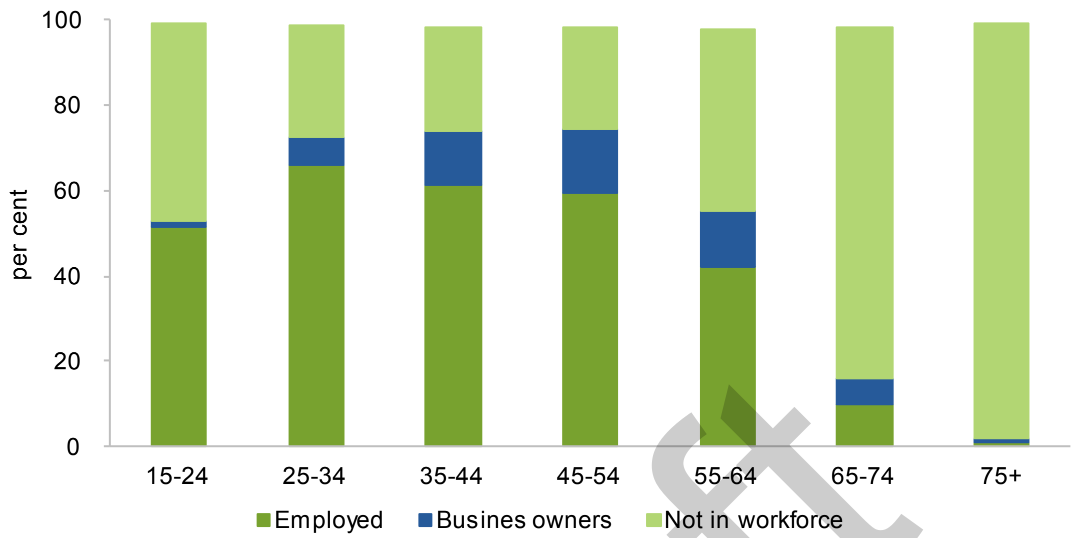
Source: ABS (2015c)

B.4 Business owners in Australia

Just over 2 million Australians owned and operated a business at the end 2012 — fewer than the number of actively trading businesses. Based on the 2011 Census of Population and Housing, business ownership was the main form of employment for around 1.5 million people (ABS 2013a).

Business owners form a small part of the population, accounting for around 17 per cent of the workforce in 2012. The rate of business ownership varies with age and is most common for those aged 45-54 years. Paid employment is more common at younger ages, peaking for those aged 25-34. While small relative to those not in the workforce, business ownership is more common than employment for those aged over 75 (figure B.9).

Figure B.9 **Employment type, by age[a]**
2011



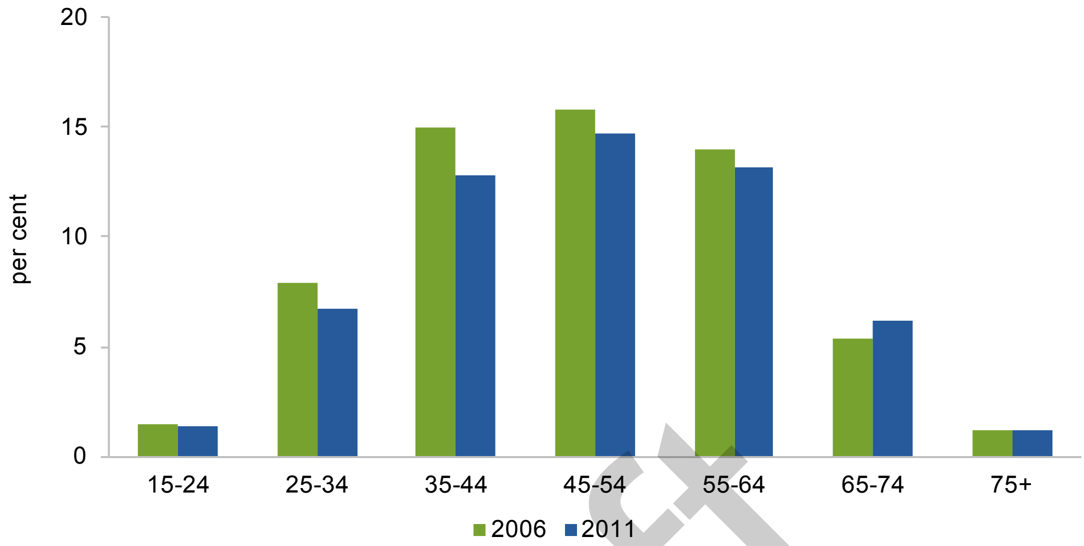
[a] Business ownership, employment and not in workforce as a proportion of the population in each age group.
Source: ABS (2013a)

Business ownership is becoming less common at younger ages

The proportion of those aged 25-34 who owned a business declined between 2006 (8 per cent) and 2011 (7 per cent). The largest proportional decline in business ownership was for those aged 35-44, while business ownership increased for those over 65 (figure B.10).

It is widely acknowledged that the Australian population is ageing (PC 2013a; Commonwealth of Australia 2015) and similar ageing trends have been observed for business owners. The average age of Australian business owners has increased (by one year between 2006 and 2011) to 47 years, in comparison to the broader workforce where the average age of 40 years has remained unchanged over the same period. Nearly 10 per cent of business owners are now beyond the traditional retirement age of 65 and another 20 per cent are within 10 years of the retirement age.

Figure B.10 **Business ownership, by age**[a]

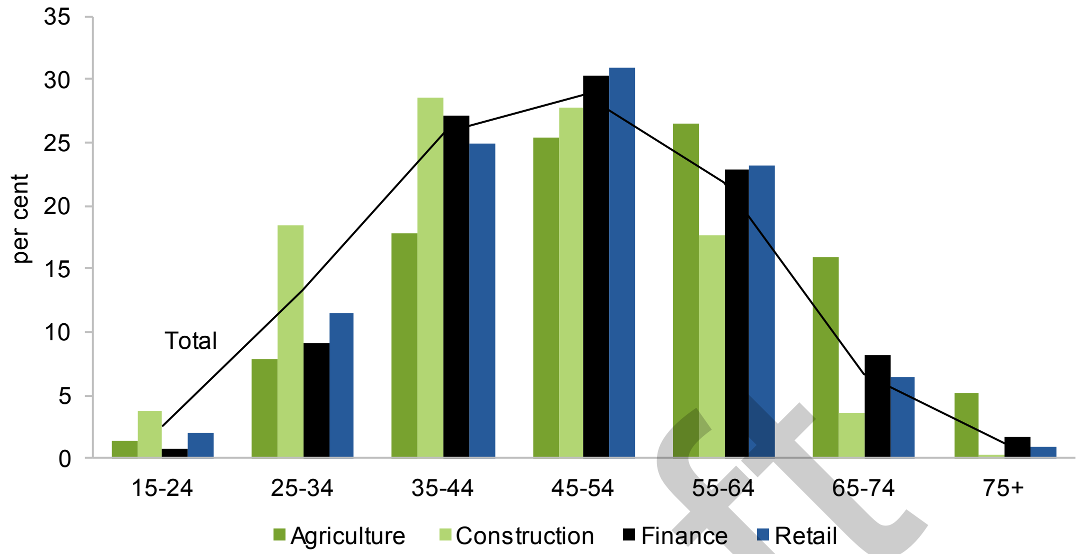


[a] Business ownership as a proportion of the population in each age group.

Source: ABS (2013a)

The age distribution of business owners differs between industries. Business owners in agriculture were generally older in 2011 — around 21 per cent were aged over 65 (average age of 54). Business owners in construction were younger with an average age of 44, while business owners in retail (average age of 48) and finance (average age of 49) were slightly older than all business owners (figure B.11).

Figure B.11 **Age distribution of business owners, by industry**[a]
2011



[a] Per cent of business owners within each industry.
Source: ABS (2013a)

Business ownership rates varies across the population

Given these trends, rates of business ownership by people from various backgrounds are explored further using 2011 Census of Population and Housing results (figure B.12).

Business owners are likely to be male

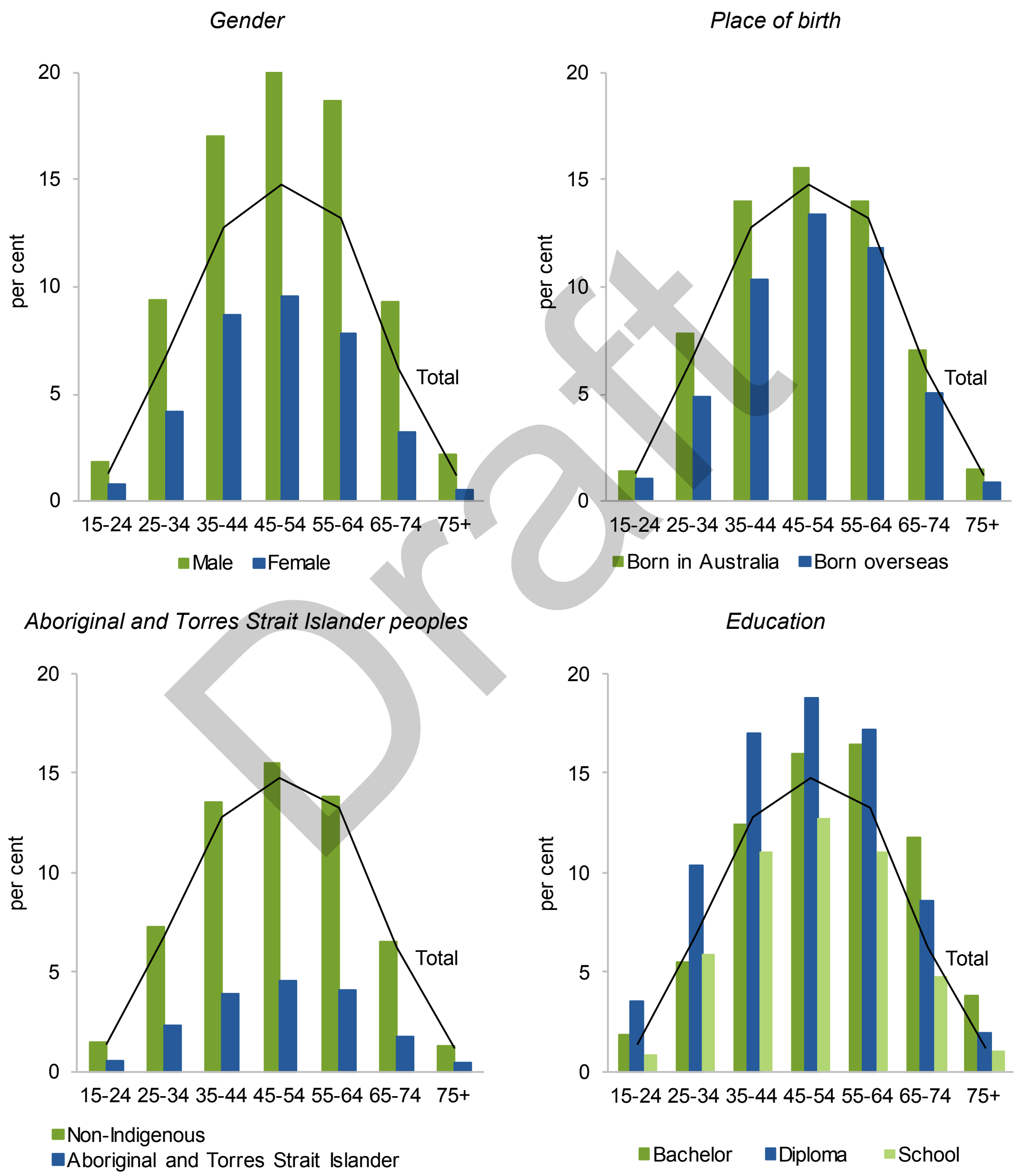
A higher proportion of men than women tend to run their own business. In 2011, business ownership was the main form of employment for around 12 per cent of males compared with 5 per cent of females. These differences are consistent across all age groups; nearly 20 per cent of males aged 45-54 owned a business in 2011, twice the rate of female business ownership in this age group.

Business owners are likely to have been born in Australia

People born in Australia (9.3 per cent) had a higher rate of business ownership than those born overseas (7.6 per cent) in 2011. Differences in business ownership between the two groups were more pronounced at younger ages. For those aged 25-34, around 7.8 per cent of those born in Australia owned a business, around 60 per cent higher than the rate of business ownership by those born overseas (4.8 per cent). Of all business owners, around

70 per cent were born in Australia. As a proportion of employed persons, self-employment by those born overseas is slightly higher than for those born in Australia (see figure B.16).

Figure B.12 **Business ownership rates, by selected characteristics[a]**
2011



[a] Business ownership as a proportion of the population in each age group.

Source: ABS (2013a)

Business ownership by Aboriginal and Torres Strait Islander peoples

Aboriginal and Torres Strait Islander people had lower rates of business ownership (3 per cent) compared with non-indigenous people (9 per cent) in 2011. Business ownership was most common for both Aboriginal and Torres Strait Islander and non-Indigenous people aged 45-54 years. On average, an Aboriginal and Torres Strait Islander business owner (43 years) was younger than a non-indigenous business owner (47 years) in 2011.

Business ownership by level of education

People with a diploma qualification (13.2 per cent) had a higher rate of business ownership than those with a university degree (10.7 per cent) or school only education (6.5 per cent) in 2011. Diploma and certificate holders aged under 35 were almost twice as likely to own a business than those with a degree.

B.5 International comparisons

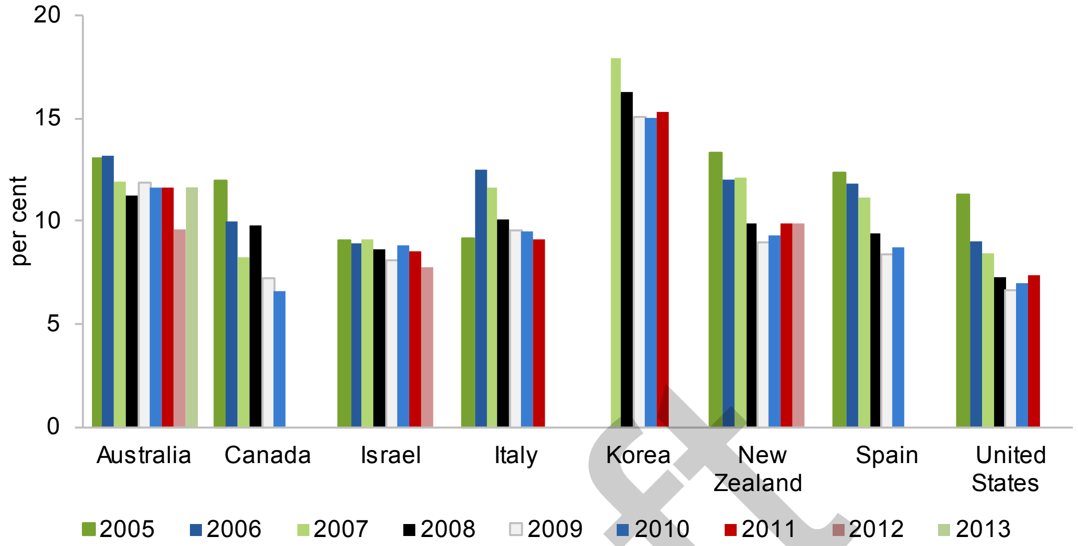
While cross-country comparisons, like those presented below, can be limited by definitional and methodological differences (Bartelsman, Haltiwanger and Scarpetta 2009), they do provide some indication of business entry and exit in Australia compared with other countries.

Many comparable OECD countries have observed a similar decline in the rate of entry and an increase in the rate of business exit in recent years. While this in part may reflect the GFC, Australia still had a relatively high set-up rate and a moderate rate of closure. New businesses in Australia tend to have a higher chance of surviving than those in other countries. Australia has similar self-employment rates to the United Kingdom and rates slightly higher than countries such as France, Germany and Israel.

Entry rates

Australia has a higher rate of set-up for employing businesses than most other comparable OECD countries. South Korea has had the highest entry rates, while Israel, Canada and the United States had lower rates than Australia between 2005 and 2013. The general decline in business formation over this period in Australia appears to be relatively modest compared with evidence in some other countries (figure B.13).

Figure B.13 **Entry rate for employing businesses, selected OECD countries[a]**



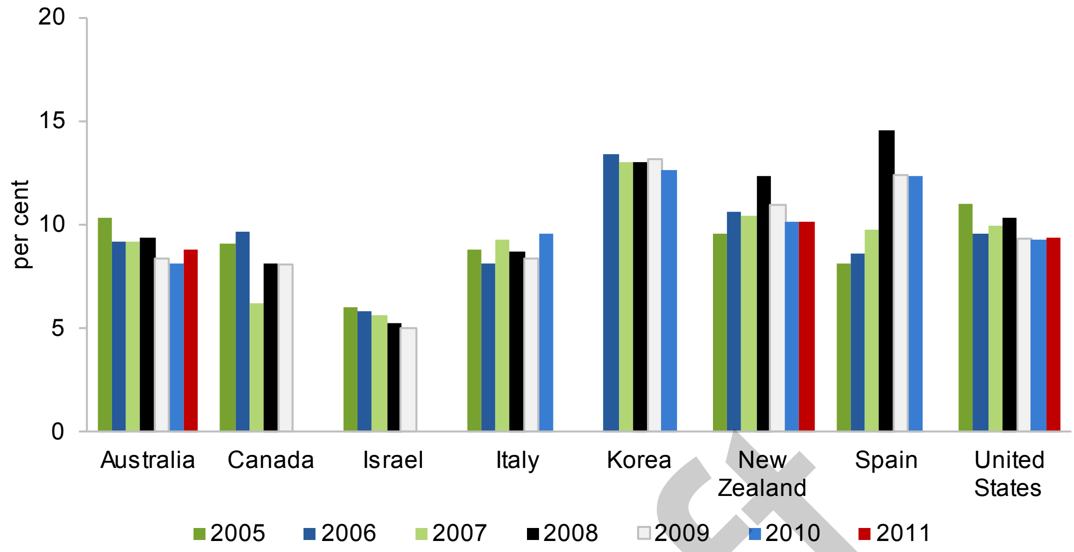
[a] The entry rate for employing businesses refers to birth of a business with at least one employee as a proportion of all active businesses with at least one employee. It does not include mergers, split-offs or restructuring of a set of businesses. International comparisons based on employing businesses have been found to be more relevant than indicators using all businesses because results are sensitive to the coverage of business registers.

Source: ABS (2007, 2014c); OECD (2013a, 2014a)

Exit rates

Australian employing businesses have similar rates of closure compared with other OECD countries. Those countries with high entry rates, such as South Korea, also had high exit rates between 2005 and 2011. The lower rates of closure in Israel and Canada were mirrored by lower entry rates. While the Australian exit rate declined marginally during this period, closures increased in some other countries (figure B.14).

Figure B.14 **Exit rate for employing businesses, selected OECD countries[a]**



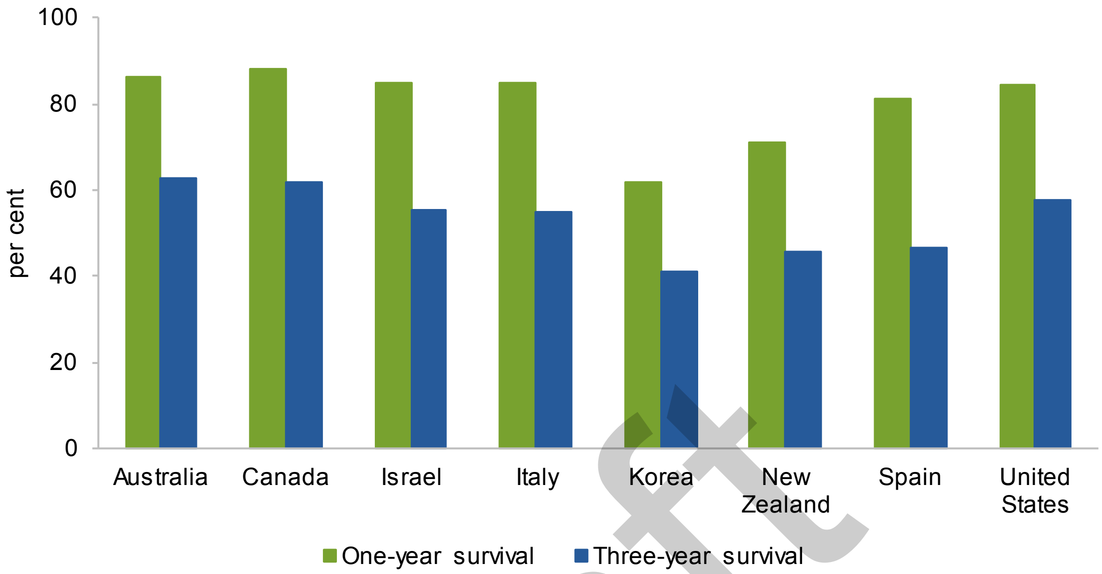
[a] The exit rate for employing businesses refers to the death of a business with at least one employee or the contraction of the business to have no employees as a proportion of all active businesses with at least one employee. It does not include mergers, split-offs or restructuring of a set of businesses. For Australia, business exits are not considered to have occurred when the business changes from having employees to no employees.

Source: ABS (2007, 2014c); OECD (2013a, 2014a)

Survival rates

New businesses in Australia tend to have a higher chance of surviving than those in other countries. Among new businesses set-up in 2006, those in Canada and Australia had higher rates of survival, while those in South Korea were least likely to survive. While this in part may reflect the onset of the GFC, it does suggest that Australian set-ups remain active for a longer period of time (figure B.15).

Figure B.15 **New business survival rates, selected OECD countries[a,b]**
2007 to 2009



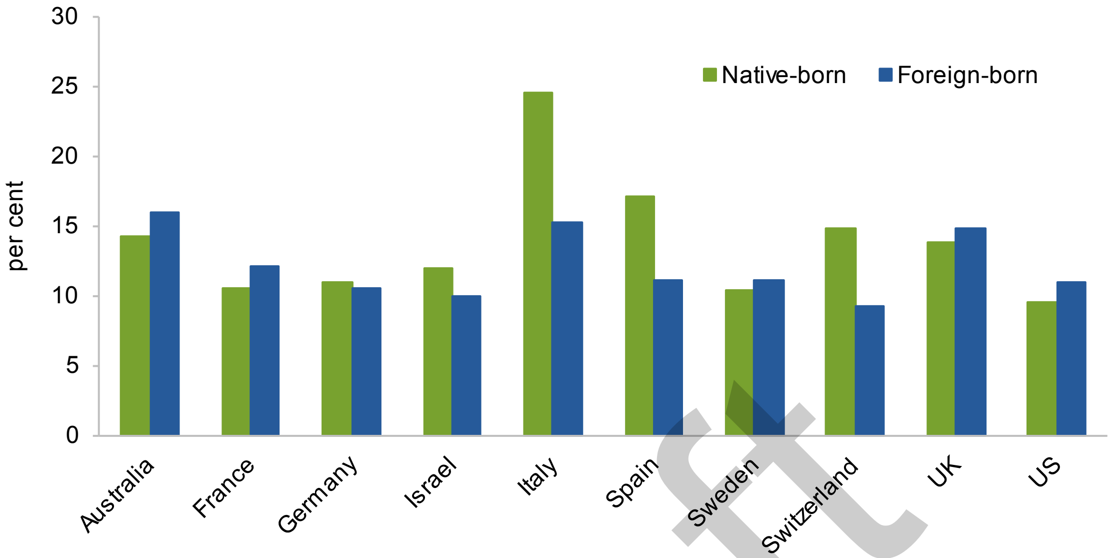
[a] Business survival rates as percentage of all employer businesses set-up in 2006. [b] The 3 year survival rate for Canada is for 2006.

Source: OECD (2013b); Industry Canada (2010)

Self-employment rate

Self-employment rates vary between countries and according to place of birth. In 2011, around 15.9 per cent of foreign-born workers were self-employed in Australia, slightly higher than the rate of self-employment by native-born workers (14.2 per cent). Australia had similar self-employment rates of native-born to foreign-born workers to the United Kingdom and rates slightly higher than France, Germany and Israel. Along with Australia, foreign-born workers had higher rates of self-employment than their native-born counterparts in France, Sweden, the United Kingdom and the United States (figure B.16).

Figure B.16 **Self-employment rate, by place of birth[a]**
2009 to 2011



a The self-employment rate by place of birth indicates the share of the employed native-born and foreign-born individuals who work as self-employed and are not working in agriculture. Australia is for 2011 and is calculated as business ownership (incorporated and unincorporated) as a proportion of employed persons, excluding contributing family workers. For all other countries, average of 2009 to 2011. For the United States, the data refer only to the unincorporated self-employed.

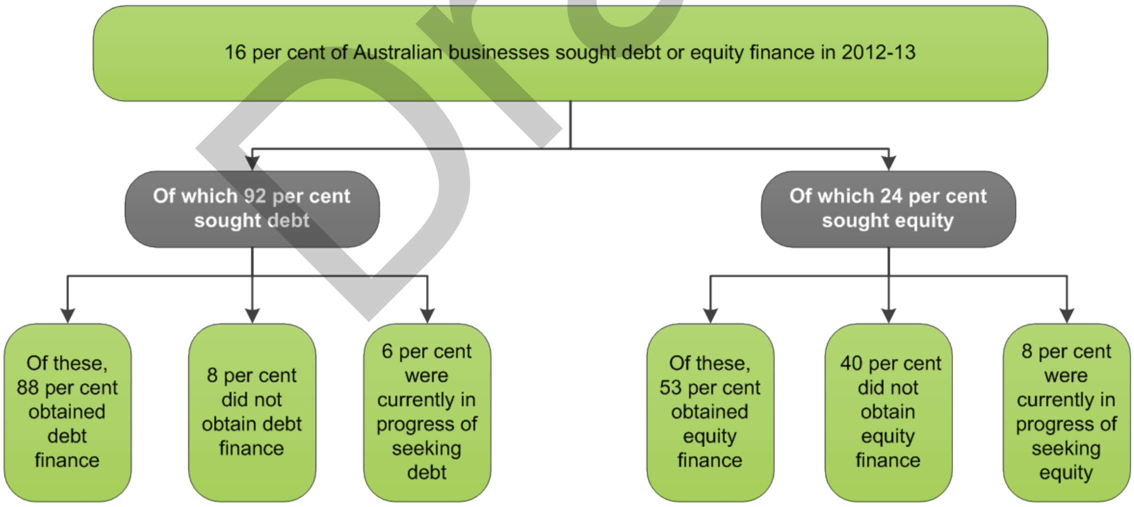
Source: ABS (2013a); OECD (2013b)

C Business finance and foreign investment data

This appendix provides a statistical overview of business lending, venture capital and private equity and foreign investment in Australia. It intends to provide additional context around the Commission's analysis of debt finance (chapter 7), equity finance (chapter 6) and foreign investment (chapter 10).

In any given year, only a minority of Australian businesses seek external finance. In 2012-13, only 16 per cent sought debt or equity finance. Businesses more commonly seek (and are more likely to obtain) debt financing over equity finance (figure C.1).

Figure C.1 **Proportion of businesses seeking and obtaining finance[a]**
2012-13

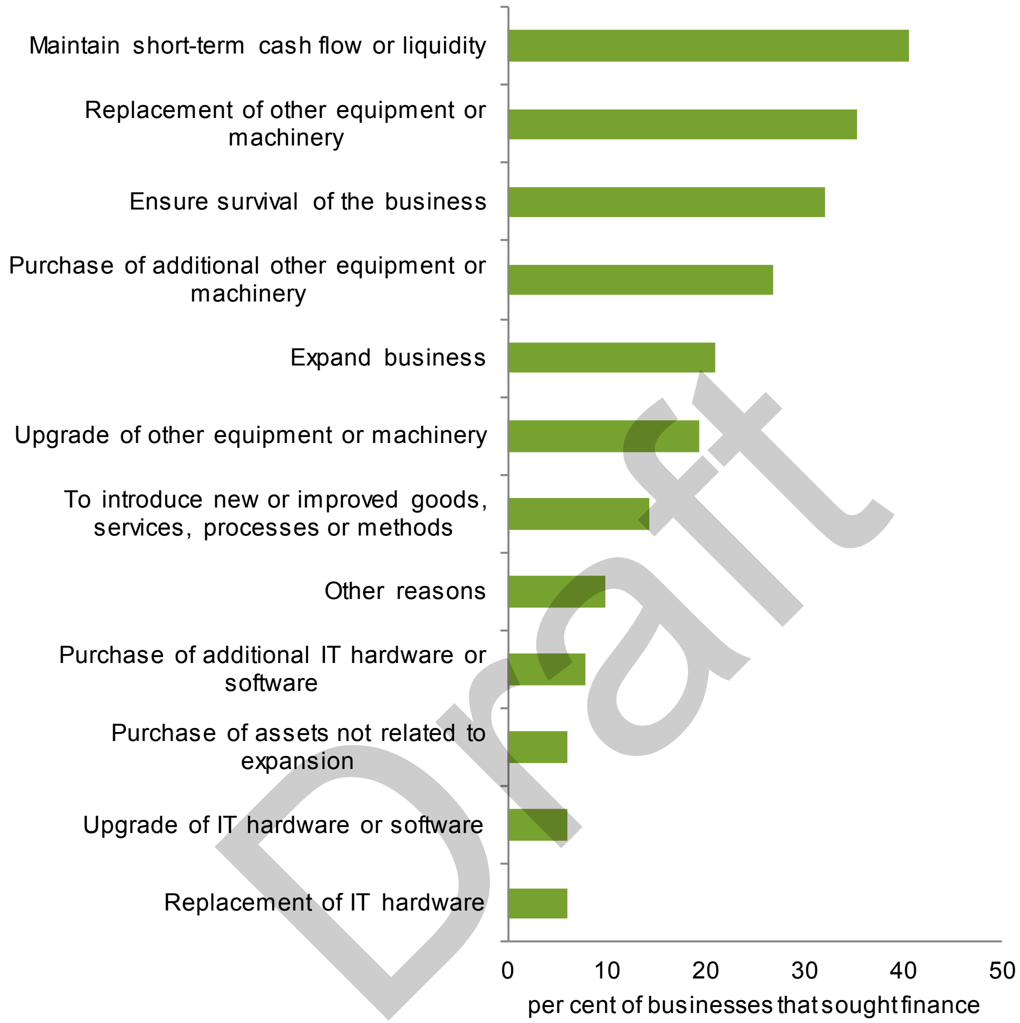


[a] Some businesses sought both debt and equity during the reference year. As such, totals may exceed 100 per cent.

Source: ABS (2014g)

The most common reason why businesses seek debt or equity finance is to maintain cash flow and liquidity, followed by the replacement of equipment and to ensure the survival of the business (figure C.2).

Figure C.2 **Reasons why businesses seek debt or equity**
2012-13



Source: ABS (2014g)

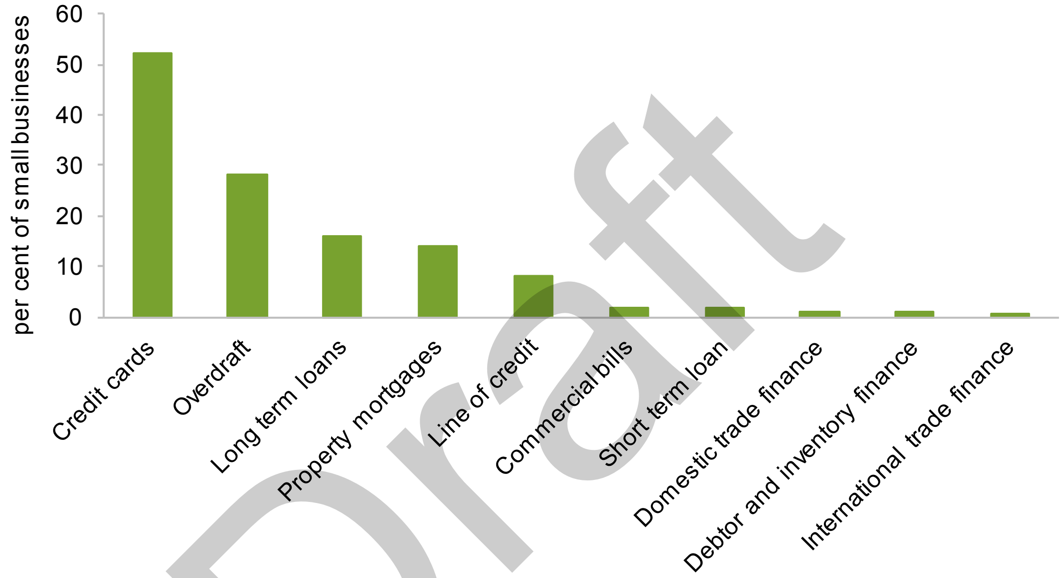
C.1 Debt finance

The primary dataset on business lending is maintained by the Reserve Bank of Australia (RBA), who collects information themselves and publishes information collected by the Australian Prudential Regulation Authority (APRA). Other sources of data on business lending include the Australian Bureau of Statistics (ABS) and survey data collected by industry and peak bodies.

The quantum of lending

As at March 2013, almost half (49 per cent) of Australian small businesses had a loan product other than a credit card. This figure increases to over 70 per cent of small businesses if credit cards are included. Credit cards represent the main lending product used by small businesses, followed by overdrafts and long term loans (figure C.3).

Figure C.3 **Debt products used by small businesses**
2013



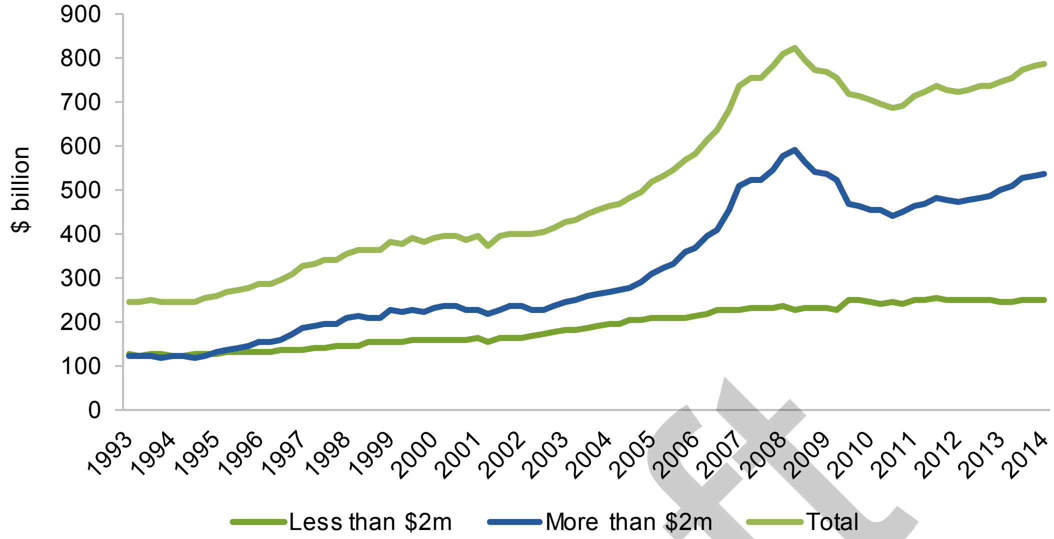
Source: ABA (2014)

As of December 2014, total bank credit outstanding to Australian businesses was just under $790 billion (figure C.4). In real terms, bank lending to businesses has generally grown strongly before falling with the beginning of the global financial crisis (GFC) in 2008. That said, 'small loans' — loans with values below $2 million — deemed by the RBA to be a measure of loans to small business continued to grow, even during the GFC.

Unfortunately, information on the stock of business lending made by non-bank institutions, such as finance companies and money market corporations is not available. However, flows data collected by the ABS indicates that relative to bank lending, these channels only represent a small part of business lending — in 2014, over 90 per cent of new commercial lending was provided by banks.

Figure C.4 **Bank lending to business — total credit outstanding by loan size**

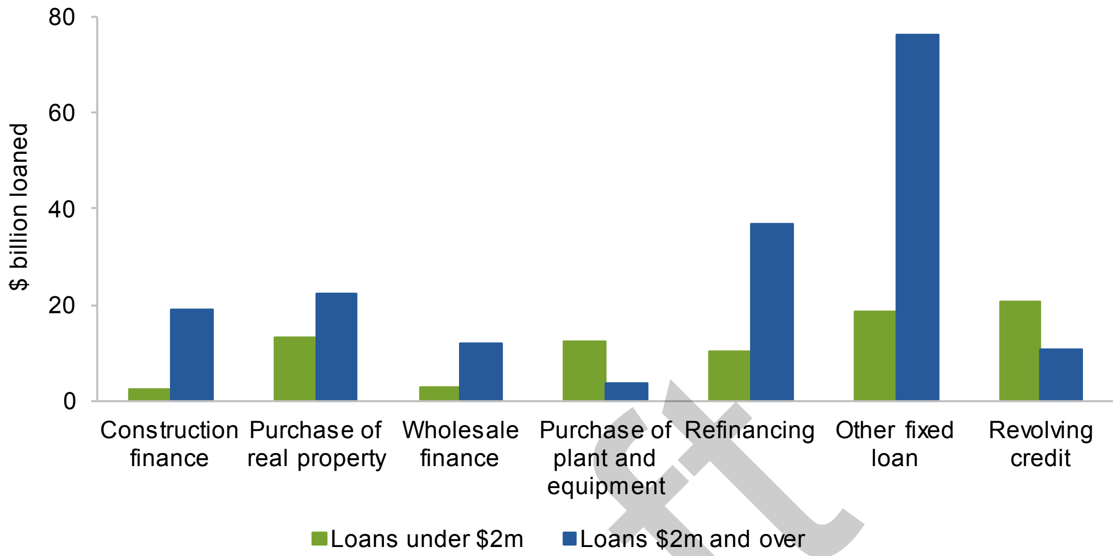
2014 dollars



Source: RBA (2015c)

RBA data also provides some insights around how businesses use bank funding and how this varies by loan size. Smaller non-revolving loans (under $2 million) are most commonly used for the purchase of real property or plant and equipment. In contrast, larger loans are commonly used for refinancing, construction finance and for purchasing real estate property (along with other, non-specified purposes — figure C.5).

Figure C.5 **Purpose of new bank loans**
2014



Source: RBA (2015c)

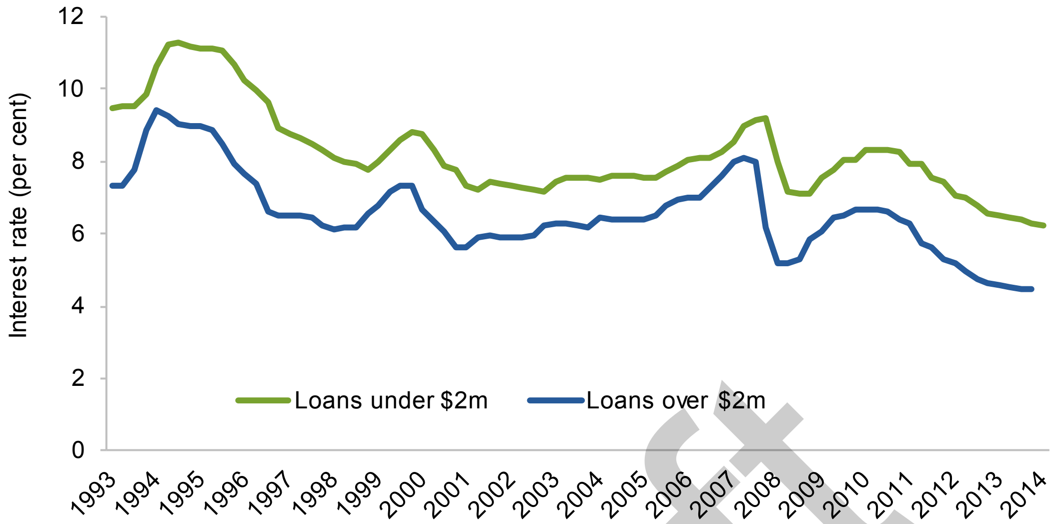
The price of lending

Chapter 7 presented that indicator rates for new small business lending was around 7 per cent in January 2015. However, if the interest rate on the entire stock of outstanding business debt[59] is examined, the rate is lower and has generally been trending downwards since data was first collected in 1993. For loans under $2 million, the average interest rate on loans outstanding in December 2014 was 6.56 per cent, and was lower (4.39 per cent) for loans $2 million and greater (figure C.6). Most (over 70 per cent) of variable rate business loans have interest rates below 7 per cent, while only a small minority (under 5 per cent) have interest rates exceeding 10 per cent per year (figure C.7).

59 Not including credit cards.

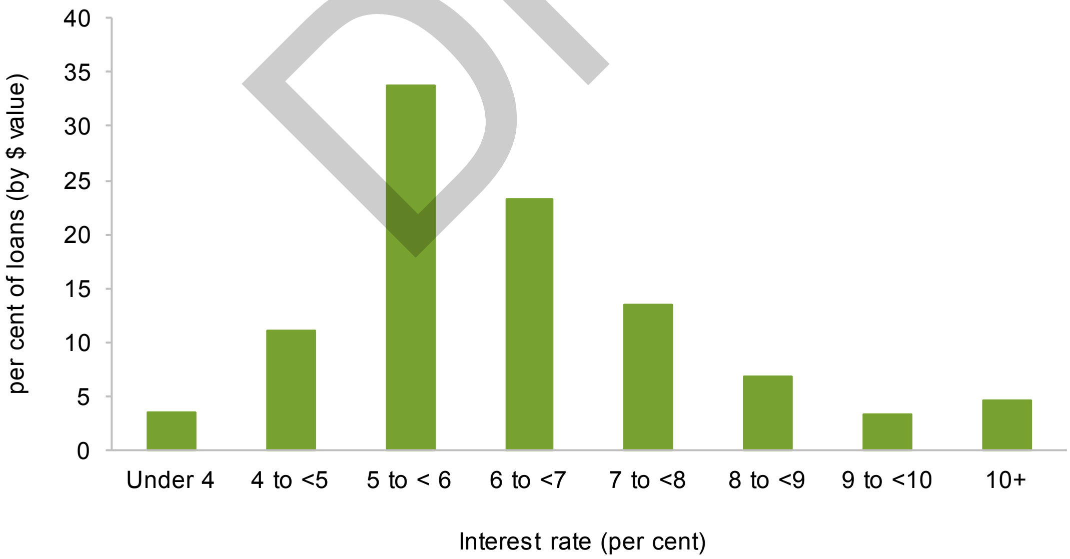
Figure C.6 **Interest rate on credit outstanding**

Weighted average



Source: RBA (2015c)

Figure C.7 **Interest rates on variable rate business loans below $2m**



Source: RBA (2015c)

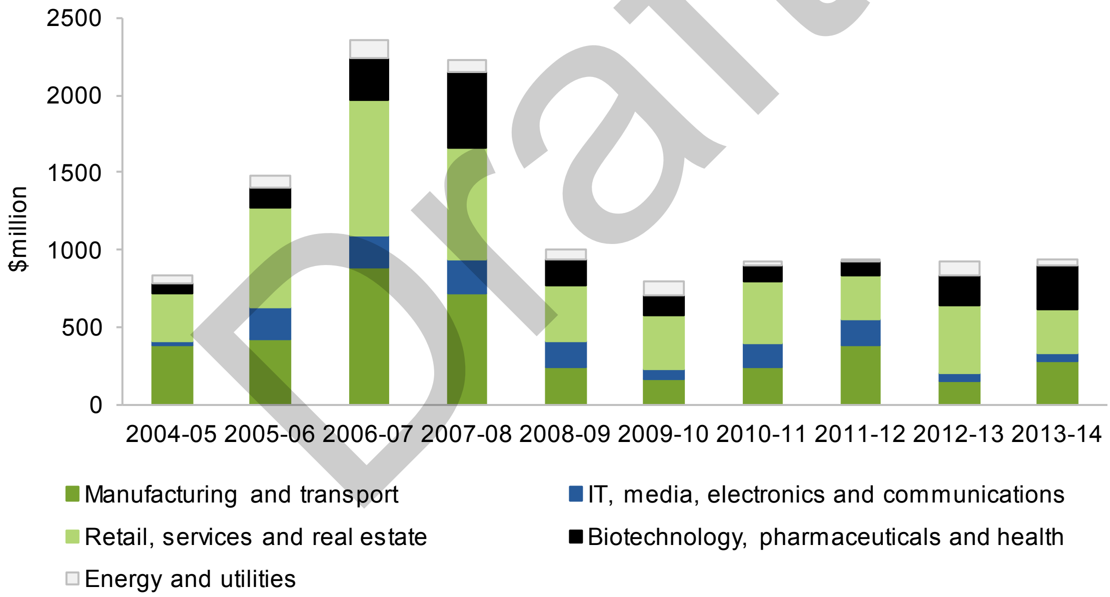
C.2 Data on venture capital and private equity

The primary data source relating to venture capital and private equity in Australia is maintained by the ABS (cat no. 5678.0).

In 2013-14, new venture capital and private equity investment in Australian businesses was just over $900 million. This represents less than half of new investment that was undertaken in 2006-07 and 2008-09, where investment exceeded $2000 million per annum.

Consistently across the last ten years, most venture capital and private equity funding has been directed at firms in the manufacturing, transport, retail, services and real estate industries (figure C.8)[60].

Figure C.8 **New investments in venture and later stage private equity by activity of investee company**

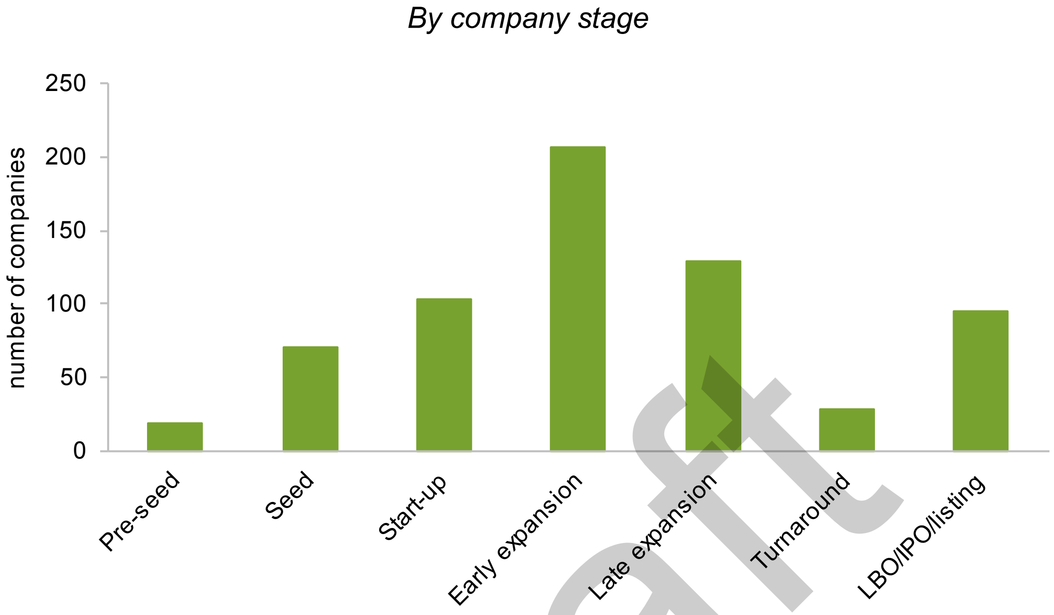


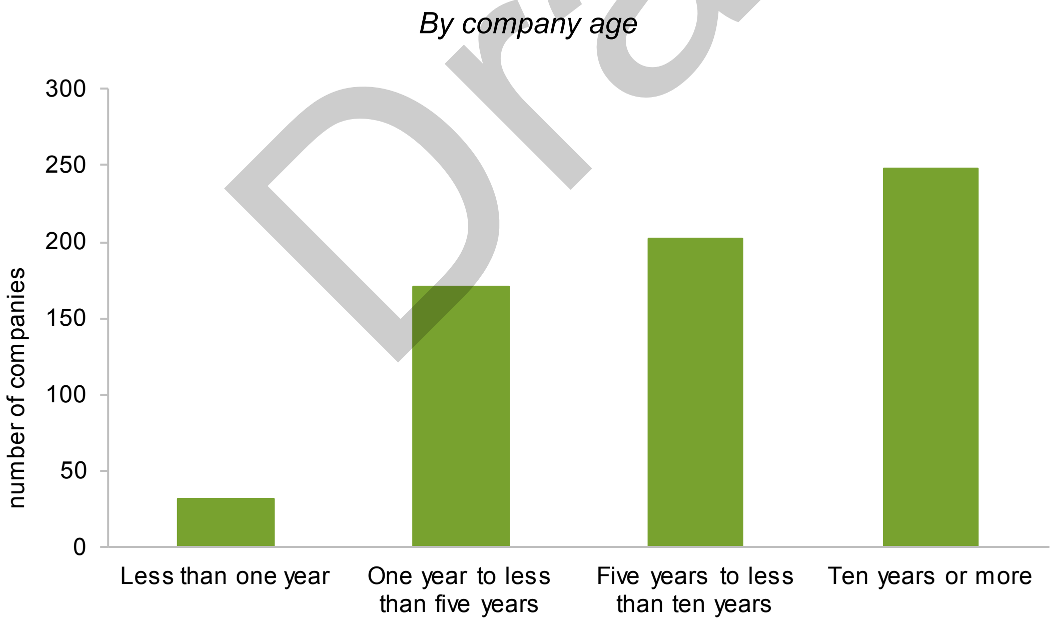
Source: ABS (2015d)

Around 700 companies received venture capital or private equity in 2013-14, although only a minority of these businesses can be considered new or young. Most companies receiving venture capital or private equity where five years old or more (figure C.9). In terms of position in the life cycle, more businesses obtained venture capital while undertaking early or late expansion than during early stages (such as during seed and start-up).

60 The exact proportion of investment directed at these industries varies between 61 per cent in 2008-09 and 82 per cent in 2004-05.

Figure C.9 **Number of companies receiving venture capital and private equity[a]**
2013-14





[a] LBO stands for leveraged buyout. IPO stands for initial public offering.

Source: ABS (2015d, table 9)

C.3 Data on foreign investment into Australia

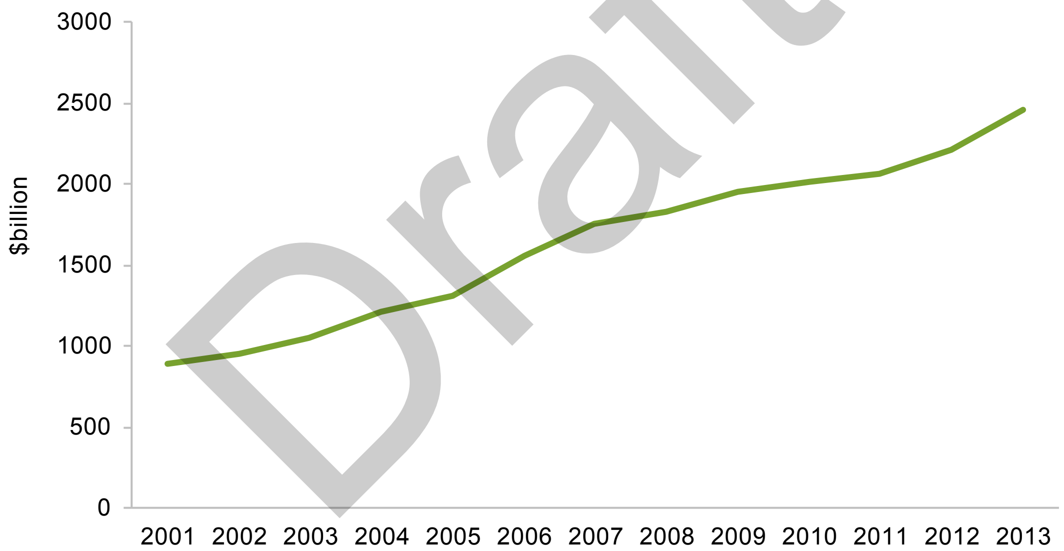
The primary data source relating to foreign investment into Australia is maintained by the ABS (cat no. 5352.0).

Quantity of foreign investment over time

As part of the dataset on Australia's international investment position, the ABS maintains quarterly (and yearly) data relating to the quantity of foreign investment into Australia. This includes details regarding the country of investor, investment stocks (level of investment), flows (transactions) and associated income.

The total stock of foreign investment in Australia has increased consistently since 2001, growing from $892 billion to a peak of $2462 billion in 2013 (figure C.10). The total stock of foreign investment in Australia in 2013 was comprised of a total of $868 billion worth of foreign equity and $1631 billion worth of foreign debt. Portfolio investment liabilities accounted for a total of $1380 billion, whilst the total value of foreign direct investment was $630 billion over the period.

Figure C.10 **Total stock of foreign investment in Australia**

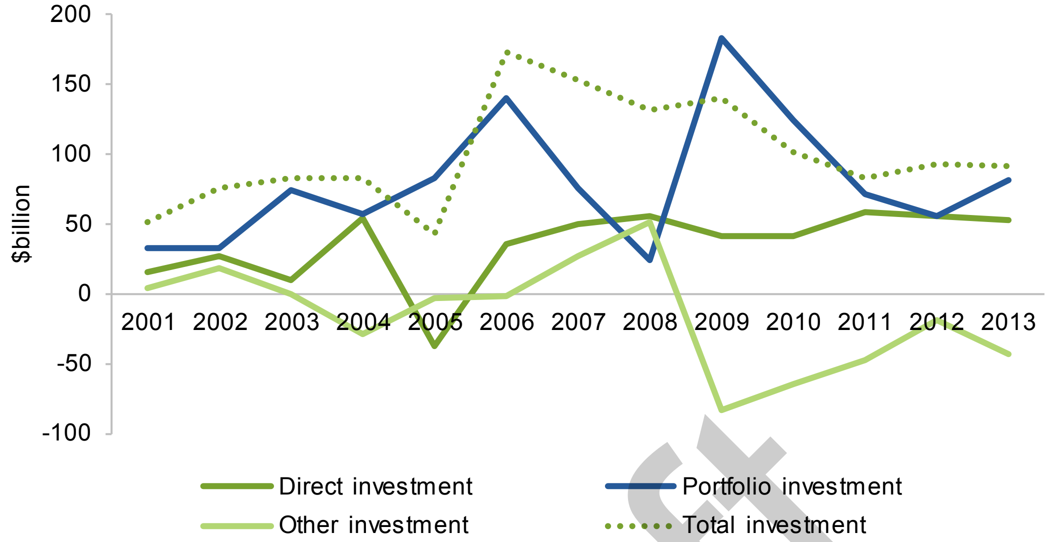


Source: ABS (2014f)

Despite the total stock of foreign investment in Australia consistently increasing over this period, the flow of foreign investment each year has fluctuated. Foreign investment flows can be seen below (figure C.11).

The total net inflow of foreign investment into Australia was valued at $91.3 billion in 2013. In the same year, portfolio investment accounted for $81.6 billion, whilst foreign direct investment was valued at $52.7 billion. Throughout the period of 2001 to 2013, total foreign investment into Australia fluctuated, reaching a peak of $173.2 billion in 2006.

Figure C.11 **Flow of foreign investment into Australia**



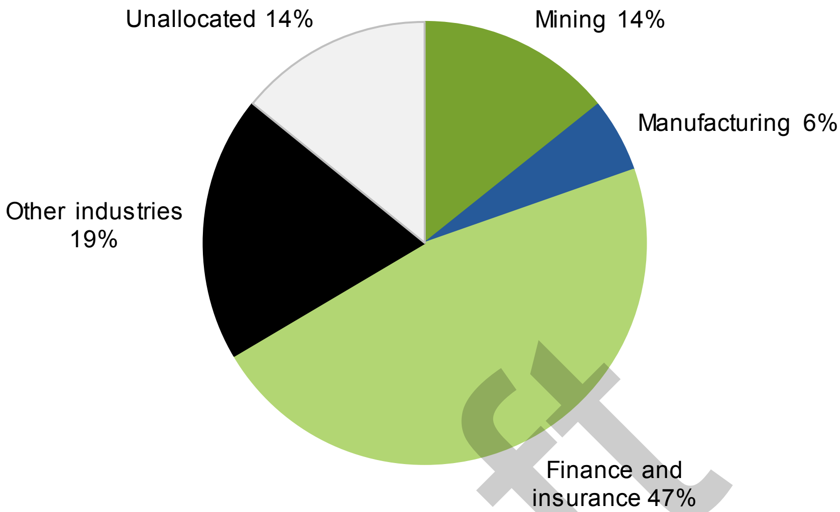
Source: ABS (2014f)

Direction of foreign investment over time

The ABS is also responsible for maintaining data relating to the direction of foreign investment into Australia (cat no. 5352.0). This dataset contains information regarding levels of foreign investment by industry division (figure C.12).

As of 31 December 2013, the ‘finance and insurance’ industry represented the greatest share of total foreign investment in Australia (47 per cent). This was followed by the ‘mining’ and ‘manufacturing’ industries, which accounted for 14 per cent and 6 per cent of the total respectively. The remainder of foreign investment into Australia was directed toward other areas, including the ‘wholesale and retail trade’, ‘transport’ and ‘electricity’ industry sectors. However, the ‘mining’ and ‘manufacturing’ industries represented the largest share of foreign direct investment (FDI) into Australia in 2013, accounting for 37 per cent and 14 per cent respectively. The ‘finance and insurance’ industry (11 per cent) was the third largest source of FDI (DFAT 2014).

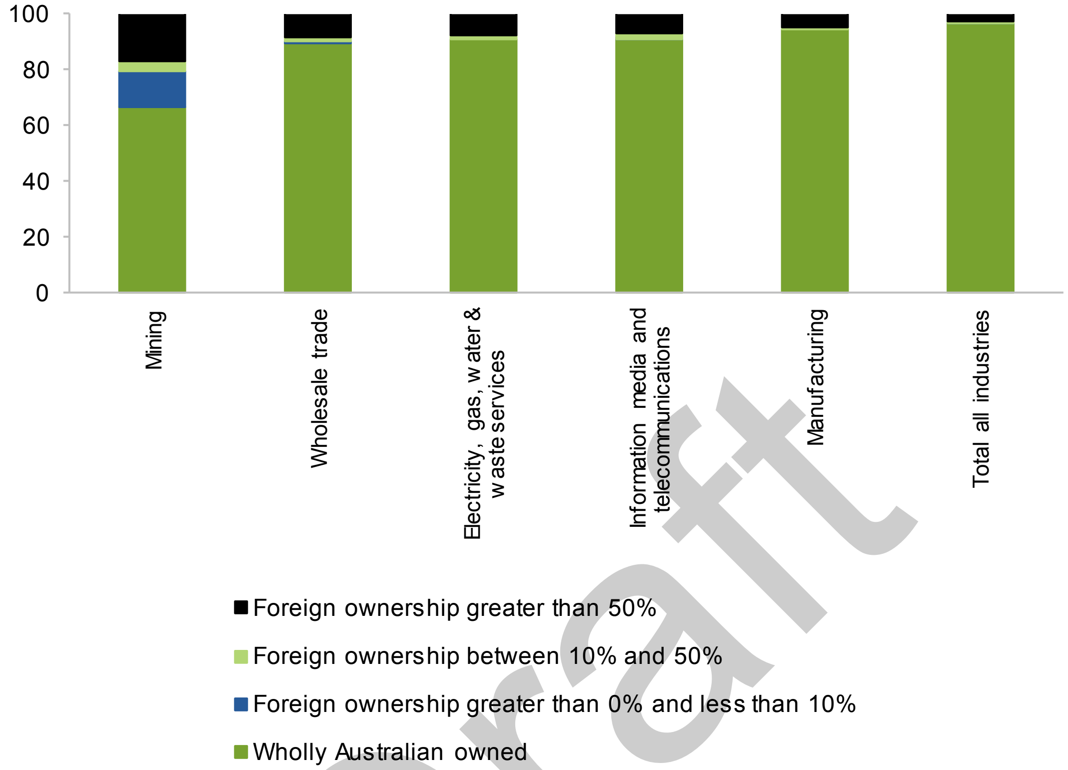
Figure C.12 **Total stock of foreign investment in Australia by industry**
2013



Source: DFAT (2014)

The ABS also maintains data relating to the proportion of foreign ownership of Australian businesses (cat no. 8167.0). 96.5 per cent of all businesses located with Australia are wholly Australian owned, however this proportion of foreign ownership varies between industry sectors (figure C.13). The 'mining' industry has the highest proportion of foreign ownership, with 33.5 per cent of businesses in the sector at least partly foreign-owned. This is followed by 'wholesale trade' (10.3 per cent), 'electricity, gas, water & waste' (9.3 per cent), 'information media and telecommunications' (9 per cent) and 'manufacturing' (5.6 per cent). All other industries are comprised of greater than 95 per cent wholly Australian owned businesses.

Figure C.13 **Foreign ownership of Australian businesses by industry**
2013



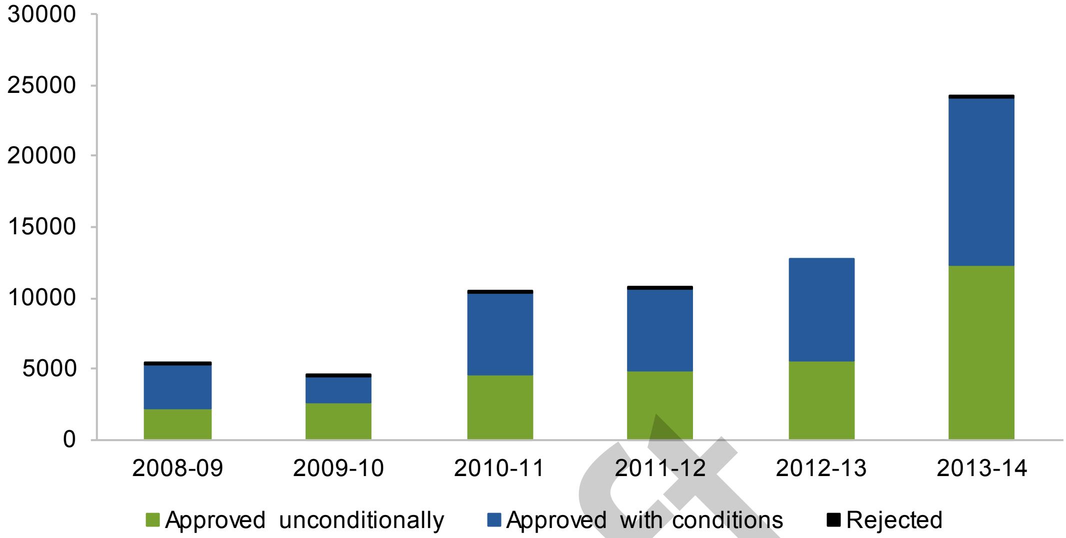
Source: DFAT (2014)

Proportion of foreign investment screened by FIRB over time

The Foreign Investment Review Board (FIRB) collates data relating to foreign applications to invest in Australia. Many foreign investments in Australia require screening and approval by FIRB before taking place. FIRB publishes data relating to these foreign investment applications each year in its annual report.

FIRB maintains data relating to the total number of foreign investment applications considered, as well as the outcome of these applications (figure C.14). The number of applications approved unconditionally has steadily increased from 2266 in 2008-09 to 12 307 in 2013-14. The number of applications approved with certain conditions being attached to the investment was more variable over the period, however still reached a peak of 11 795 in 2013-14. Very few proposals were rejected over this time period, with the largest number of rejections occurring during 2010-11 (43) and no rejections occurring during 2012-13.

Figure C.14 **Number of applications considered by FIRB**

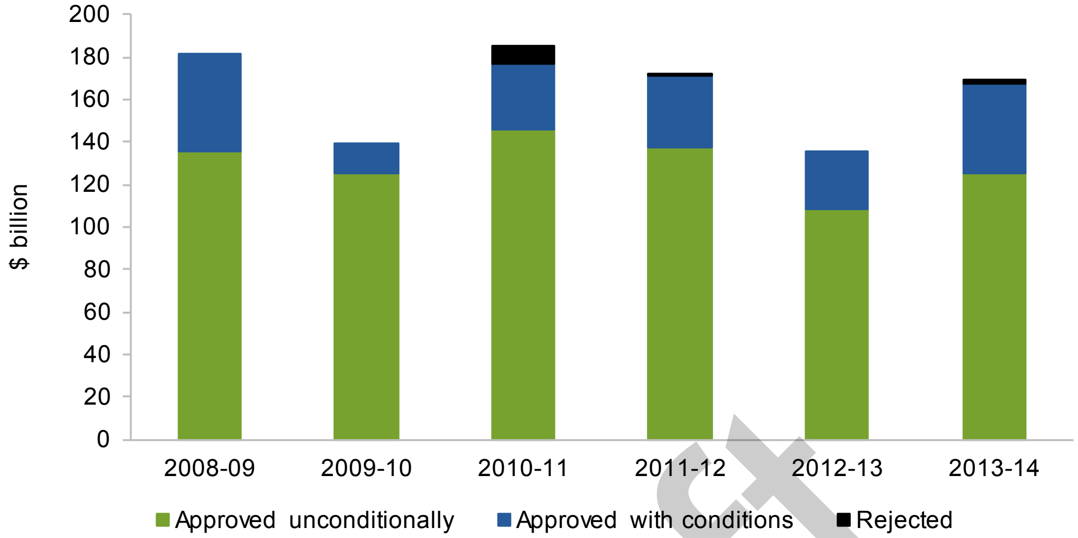


Source: FIRB (2015a)

FIRB also maintains data relating to the monetary value of foreign investment applications that require screening (figure C.15). The value of applications approved unconditionally has declined from $135.9 billion in 2008-09 to $125.3 billion in 2013-14, despite the total number of such applications increasing over the period. The value of applications approved with certain conditions being attached to the investment has declined slightly, from $45.5 billion in 2008-09 to $42.1 billion in 2013-14. The total value of rejected proposals was very low over this time period, with the highest recorded value of rejections occurring during 2010-11 ($8.8 billion).

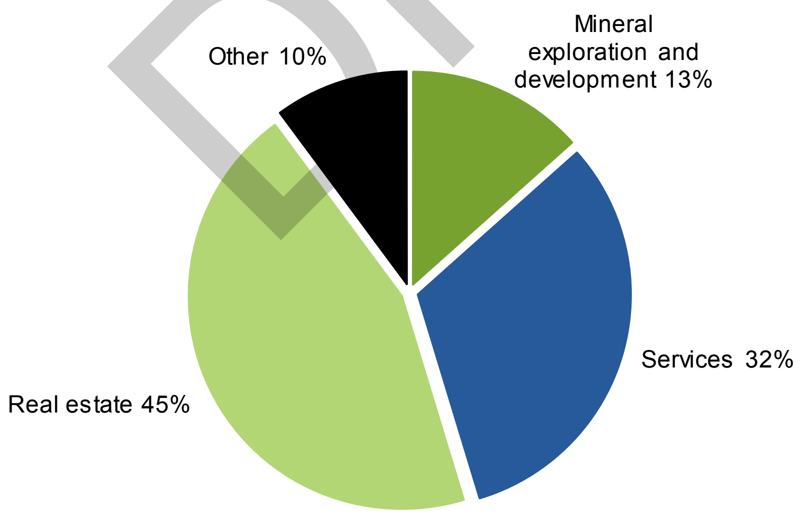
FIRB also considers the value of approved applications by industry sector. During 2013-14, the real estate industry was responsible for the largest proportion (45 per cent) of the total value of approved applications. This was followed by the 'services' and 'mineral exploration and development' industries, which accounted for 32 per cent and 13 per cent of the total respectively. The remainder of applications approved by FIRB accounted for a combined 10 per cent of the total (figure C.16).

Figure C.15 **Value of applications considered by FIRB**



Source: FIRB (2015a)

Figure C.16 **Value of FIRB approvals by industry sector**
2013-14



Source FIRB (2015a)

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