



**Australian Government**  
**Productivity Commission**

# Business Set-up, Transfer and Closure

# Productivity Commission Inquiry Report

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Media and Publications, phone: (03) 9653 2244 or email: [maps@pc.gov.au](mailto:maps@pc.gov.au)

### 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](http://www.pc.gov.au)).



**Australian Government**  
**Productivity Commission**

***Canberra Office***

Level 2, 15 Moore Street  
Canberra ACT 2600

GPO Box 1428  
Canberra ACT 2601

Telephone 02 6240 3200

Facsimile 02 6240 3399

***Melbourne Office***

Telephone 03 9653 2100

[www.pc.gov.au](http://www.pc.gov.au)

30 September 2015

The Hon Scott Morrison MP  
Treasurer  
Parliament House  
CANBERRA ACT 2600

Dear Treasurer

In accordance with Section 11 of the *Productivity Commission Act 1998*, we have pleasure in submitting to you the Commission's final report into *Business Set-up, Transfer and Closure*.

Yours sincerely

A handwritten signature in black ink, appearing to be 'W. Mundy'.

Dr Warren Mundy  
Presiding Commissioner

A handwritten signature in black ink, appearing to be 'M. Cilento'.

Melinda Cilento  
Commissioner

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# 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]

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## Letter of extension



TREASURER

Mr Peter Harris AO  
Chairman  
Productivity Commission  
Locked Bag 2 Collins St East  
MELBOURNE VIC 8003

02 JUL 2015

Dear Mr Harris *Peter*

Thank you for your letter of 18 June 2015 seeking an extension of the reporting date for the Commission's inquiry into Business Set-up, Transfer and Closure.

I understand you are seeking an extension to 30 September 2015. The current due date is 19 August 2015.

On the basis that this extension would enable the Commission to investigate new models being used to start up businesses in Australia and overseas, as well as allow greater attention to lessening impediments to an entrepreneurial culture in Australia, I agree to extend the delivery date of the final report to no later than 30 September 2015.

I have copied this letter to the Prime Minister and the Minister for Small Business.

Yours sincerely

*J. B. Hockey*  
HON J. B. HOCKEY MP

Parliament House Canberra ACT 2600  
Australia  
Telephone: 02 6277 7340 Facsimile: 02 6273 3420

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## **Disclosure of interests**

The *Productivity Commission Act 1998* specifies that where Commissioners have or acquire interests, pecuniary or otherwise, that could conflict with the proper performance of their functions during an inquiry they must disclose the interests.

Dr Warren Mundy has advised he is a Fellow of the Australian Institute of Company Directors and the Chair of a Subject Advisory Committee for a course that is part of the Governance Institute of Australia's Diploma of Applied Corporate Governance. He played no role in the preparation of the submissions made by these organisation to this Inquiry. He is also the director of a number of private companies, none of which participated in any way in this Inquiry.

Ms Melinda Cilento has advised she is a graduate of the Australian Institute of Company Directors. She played no role in the preparation of the submission made by that organisation to this Inquiry. She is also the director of a number of public and private companies, none of which participated in any way in this Inquiry.

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<b>B Business stock, entry and exit data for Australia and overseas</b>	
<b>C Set-up requirements</b>	
<b>D Business finance and foreign investment data</b>	
<b>E Government support for business set-up</b>	
<b>F Insolvency data</b>	

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# Acknowledgments

The Commissioners would like to express their appreciation to the staff who worked on the inquiry report and underlying analysis. The staff team was led by Rosalyn Bell and included Joanna Abhayaratna, Monika Binder, Mark Bryant, Bronwyn Fisher, Bill Henderson, Timothy Hewett, James Hunter, Andrew Irwin, Paulene McCalman, Daniel McDonald, Troy Podbury, other staff in the Canberra office, and Dessy Bonita, a visiting researcher from the Indonesian Ministry of Finance, Fiscal Policy Office.

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# 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
AICD	Australian Institute of Company Directors
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
CPA	Certified Practising Accountants
CSIRO	Commonwealth Scientific and Industrial Research Organisation
FSI	Financial System Inquiry
GDP	gross domestic product

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GFC	global financial crisis
GST	goods and services tax
ICT	information and communications technology
IP	intellectual property
IPO	initial public offering
MIT	Massachusetts Institute of Technology
NAB	National Australia Bank
OECD	Organisation for Economic Co-operation and Development
PC	Productivity Commission
RBA	Reserve Bank of Australia
SME	small and medium-sized enterprise
STEM	science, technology, engineering and mathematics
TFN	tax file number
VC	venture capital

## **Explanations**

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

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# OVERVIEW

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## Key points

- Businesses are set-up for a variety of reasons and in any one year there is a churn of business entries and exits in Australia that is comparable with other countries. Most businesses start and remain small, and a very low proportion can be described as innovative.
- While it is relatively easy to start a business, a number of longstanding issues with specific regulatory requirements, regulator engagement and funding remain unaddressed. These make entry for some new businesses unnecessarily complex or costly.
- Some new business models, particularly those that exploit digital technology, challenge existing regulatory arrangements or cause associated businesses to operate in regulatory grey areas.
  - An across-the-board legislative shift is required to enable explicit exemption of classes of new 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.
  - The default position of governments should be to allow entry of innovative new business models, not restrict them or protect incumbents.
- There is a growing focus among governments on high growth potential start-ups and the role entrepreneurial communities play in start-up success. The significance of entrepreneurial communities requires a more nuanced role for government. Any assistance programs must work within, and not distort, existing entrepreneurial communities to enable the capture of knowledge and network spillovers, beyond what would otherwise occur.
- Access to finance is not a significant barrier for most new businesses — most, with good reason, do not seek finance from external sources.
  - New financing platforms, such as peer-to-peer lending, are helping to fill a gap in unsecured debt finance available from the major financial institutions.
  - The planned new regulatory framework for crowd-sourced equity should balance the financing needs of business against the risk preferences of different types of investors.
  - High growth potential start-ups are generally able to attract angel and venture capital funding from Australian or overseas markets.
- Most businesses are closed or transferred without financial failure. Governments' role in such situations should be limited to provision of clear guidelines on regulatory requirements and arrangements, and ensuring government processes are timely.
- Some specific reforms to Australia's corporate insolvency regime are warranted, but a wholesale change to the system, such as the adoption of the United States' 'chapter 11' framework, is neither justified nor likely to be beneficial.
  - Formal company restructuring through voluntary administration should only be available when a company is capable of being a viable business in the future.
  - A 'safe harbour' defence should be introduced to allow directors of a solvent company to explore, within guidelines, 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 few or no recoverable assets.
  - All directors should be required to obtain a director identification number.
- The default exclusion period and restrictions on bankrupts in relation to access to finance, employment and overseas travel should be reduced from 3 years to 1 year, with the trustee and courts able to extend this period to prevent abuse. The obligation to repay debts should continue to be required for 3 years or until bankruptcy discharge.



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# 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, have ambitious growth expectations and a desire ‘to change the way things are done’. At the other end are those businesses that satisfy a lifestyle choice and/or primarily seek to provide stable employment and income for the owners and their families. 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 redeployed quickly elsewhere in the economy, and that prospective new business ideas 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 entrepreneurial activity, risk or to business failure). The Commission has undertaken a broad ranging investigation into these impediments and recommended ways to remove or reduce them in order to improve the overall efficiency and effectiveness of market operations.

This report provides important advice for public policy on disruptive new business models, government approaches to supporting start-ups and an entrepreneurial culture, and closure processes for insolvent businesses.

## **The business landscape is evolving**

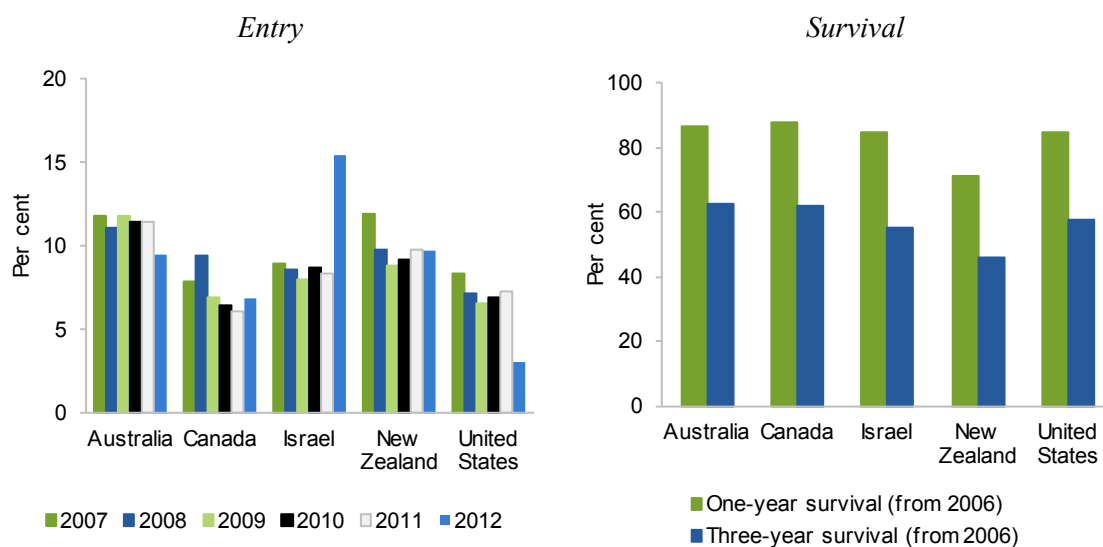
There are around 2.6 million businesses registered as operating in Australia. Variation in the rate of business entry and exits is low year to year (for all business size groups). Australia has relatively high business entry rates when compared with other countries, and survival rates that are comparable with those in the United States and Canada and above those of New Zealand (figure 1).

While most new businesses in recent years have formed as either sole traders or companies, many of these are established for a very limited time — sometimes for the life of a single property development, a single product line or when owners are between other employment opportunities.

The vast majority (over 90 per cent) of new businesses are micro-businesses with few (less than four) or no employees. The median age of business owners (at 47 years) is older than the general workforce and is increasing faster. Most young Australians undertake further study or training rather than start a business. The majority of business owners are male, but female owners are becoming more prevalent in new businesses. For example, greater accessibility of technology such as the Internet in homes, and economic and lifestyle considerations, has given rise to ‘mumpreneurs’.

Most new business owners are not ‘entrepreneurs’. Entrepreneurs are noted for their growth aspirations, capacity to be innovative, take risks and bring about change — not just replicate existing business models. Nevertheless, it is far easier being an entrepreneur if there are other entrepreneurs nearby to connect and work with. It is this, combined with the complexity and speed of innovation processes, that has given rise to market-driven business incubators, accelerators and co-working spaces that link entrepreneurs with each other, and with mentors and advisors, finance sources, universities, and government agencies. It is the interactions between these parties that are at the heart of entrepreneurial communities.

Figure 1 **Business entry and survival rates in Australia and overseas<sup>a</sup>**



<sup>a</sup> Entry and survival rates are for employing businesses only which, in Australia’s case, means the reported entry rate is slightly below, and the reported survival rate slightly above, the total business rates.

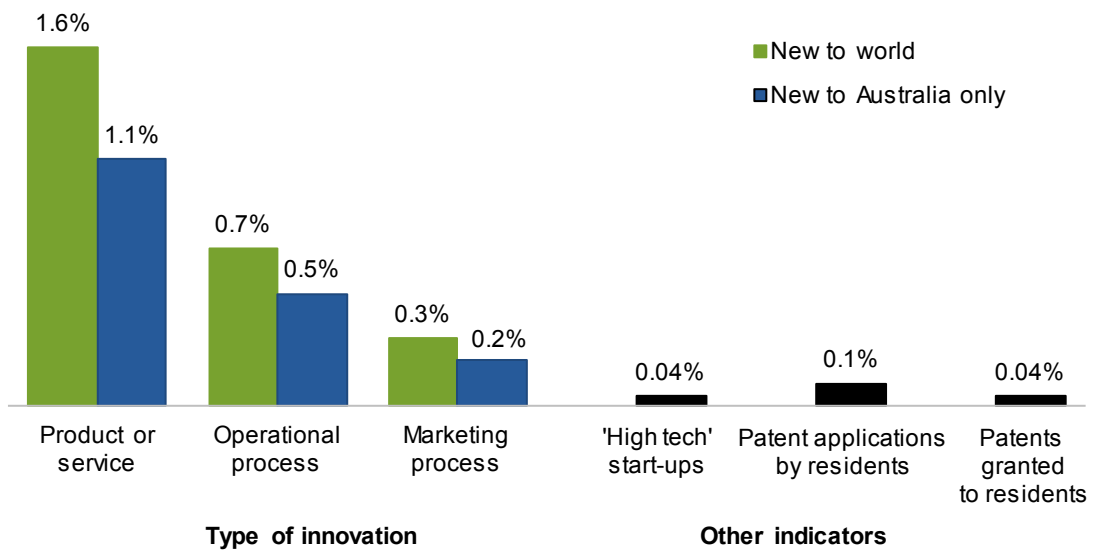
## A small group are innovative

Just as not all new business owners are entrepreneurs, so too, not all new businesses are ‘start-ups’ — newly created businesses that are innovative (in either a low or high tech way), with high growth potential and aspirations. In fact, less than 0.5 per cent of Australia’s new businesses are considered to be start-ups and only around 1-2 per cent of the stock 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) (this compares 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 Canada and New Zealand but below the United States and the United Kingdom. Across all OECD countries, high growth innovative businesses typically account for around 2-6 per cent of all businesses.

Micro and small businesses are far less likely to engage in innovative activity than larger businesses, although new businesses (which typically are micro or small) are far more likely to be innovative and contribute to net growth in employment, than are older 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. This suggests that — apart from the very small proportion of new businesses that are start-ups — there is a large body of older, deliberately small, non-innovative businesses in the Australian economy. These businesses do, however, play an important role as innovation adopters — small businesses accounted for over 80 per cent of all adoptive innovations (new to the industry or business only) in 2012-13. The uptake of previously introduced goods, services and processes facilitates the diffusion of new ideas and efficient business practices across the economy, helping create the environment that enables new business models.

**Figure 2 Innovative business activity**  
Per cent of all actively trading Australian businesses in 2012-13



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## **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 (such as Uber transport services or PayPal facilities) 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. Yet other businesses are emerging from what has become known as the ‘maker movement’ — groups of individuals who collaborate and create by exploiting the ready availability of technology traditionally only accessible to large businesses, to experiment and develop innovative products. What these new business models have in common is the scope to improve consumer choice, increase the utilisation of existing capital or labour, and/or lower the prices at which products or services are provided.

Where these new models have entered existing Australian 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 prevailing regulatory frameworks (such as online employment matching services), others are challenging regulatory arrangements or causing other businesses or 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 greatest 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.

### **Regulatory response to disruptive business models**

Government and regulator responses to new business models are critical to their success. ‘Knee-jerk’ reactions that are overly prescriptive and shield incumbent businesses from competition, impose unnecessarily high costs on new business entrants and therefore consumers, discourage innovation and reduce economic growth. For example, reaction by some local governments against households providing temporary accommodation through Airbnb is more likely to reduce general activity and incomes in the local area, than it is to improve public health and safety or deliver on any misguided government aims to protect the business of local motels.

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The Commission considers that regulators need to be able to respond flexibly and transparently to new business models not previously contemplated that are challenging regulatory requirements and ensure that regulatory frameworks are capable of adapting quickly to cope with transformative technology developments. This could be achieved by Australian parliaments passing general legislation (that is, not specific to any given regulatory area) to empower Ministers, on advice from regulators, 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 existing regulations). Such exemptions would be disallowable instruments and subject to parliamentary scrutiny and public review prior to expiration.

The provision of exemptions would enable existing regulatory arrangements to be reviewed without unnecessarily inhibiting or delaying new business activity. 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.

The Commission found a need to improve the clarity of requirements for new stored value systems, provide greater transparency around regulator processes and decision-making on access and designation of payment systems, and strengthen the focus on competition in the financial system more generally. The existing regulatory regime for access to payment systems leaves a gap between the Australian Consumer and Competition Commission being able to take action on evidence of anticompetitive behaviour in payment systems and the Payments System Board (contained within the Reserve Bank of Australia) setting an access regime after ‘designating’ a particular payment system. Whilst this arrangement has a good deal of policy similarity with the National Access Regime (NAR) contained in Part IIIA of the *Competition and Consumer Act 2010* (Cth), it lacks the transparency and accountability of the NAR. In particular, it does not provide for those seeking access to a particular payment system to formally seek designation, nor require reasons for a decision to be publicly provided, or for affected parties — either the access seeker or the access provider — to seek independent review of the decision. The Commission is making recommendations to rectify this situation.

The Commission also sees merit in digital currency businesses being brought within existing regulatory frameworks for anti-money laundering and counter-terrorism financing, given the high growth potential of digital currencies and the likely low costs of their inclusion in regulatory frameworks.

## **Long standing regulatory issues remain unaddressed**

Some of the most beneficial regulatory changes that governments can make to facilitate business entry and exit relate not just to those new businesses that disrupt existing

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arrangements, but also to the much greater number of traditional-style or ‘replicative’ new businesses.

Which regulatory requirements and arrangements apply when establishing or closing a business 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. In general, it appears to be comparatively quick and easy to establish a business in Australia. That said, requirements and experiences 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. Of course, some regulatory requirements are necessary to achieve public policy objectives, such as public safety or fair trading. However, even with well-intentioned regulation, outcomes depend critically on the regulation design, implementation and enforcement.

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 registration and compliance processes. This is a good starting point for new businesses, but the liaison with regulators and associated paperwork and inspections for the issue (and renewal) of licences remain areas that many new (and established) businesses find particularly time-consuming and costly. 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.

The Commission was advised that for businesses looking to establish interstate or locate in Australia from overseas, determining which parts of the government bureaucracy apply in each state or territory and what are the relevant regulatory requirements, can be particularly burdensome. There remains scope for governments to increase the usefulness of information on regulatory requirements. There also remain considerable barriers (with no apparent public benefit) in some professions to the use of skilled labour resources either from interstate or overseas.

Much of the inaction on recommended regulatory reforms by primarily state, territory and local governments, reflects a lack of political will to change arrangements faced by incumbent businesses, and as identified by the Commission in its past work on regulator engagement, an unwillingness by some state governments to deal with the complications posed by large numbers of poorly resourced and incentivised local governments. For example, many zoning and development assessment requirements remain unnecessarily interventionist, costly, time consuming, duplicative of sector-specific agreed national requirements, and restrictive (without public benefit) in how particular buildings or sites can be used.

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The Commission recommends that all governments take timely and effective action on previous recommendations of the Commission and others that remain valid and largely unimplemented. Continued failure to act on these recommendations needlessly hinders the establishment and closing of businesses, and creates ongoing unnecessary costs to businesses, communities and taxpayers.

## **Fostering entrepreneurial activity**

Governments have a long history of providing support to businesses in various guises — grants, concessional loans, tax concessions, subsidised services — usually in an attempt to make it easier for businesses to set-up or delay their demise. This is often motivated by a desire for stronger local growth, investment and employment, or is occasionally related to broader underlying social objectives such as reducing the inequality in services or opportunities faced by a particular disadvantaged group in the community.

Such interventions have typically involved governments promoting chosen sectors, businesses or categories of business (such as small business), often with weak underlying economic rationale. These interventions come at the expense of other businesses (and ultimately taxpayers) that are able to operate successfully in markets without ongoing government support.

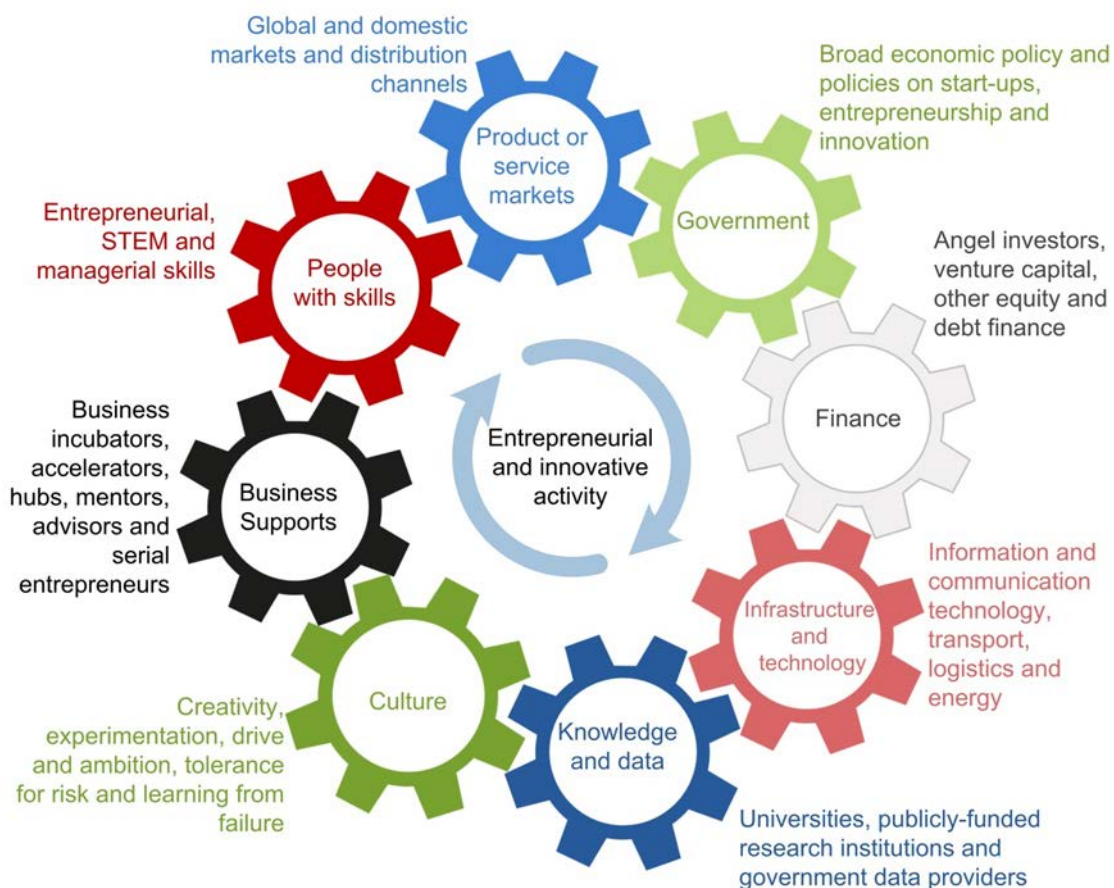
Increasingly, governments around the world have shifted their policy focus from promoting business creation in general, to enabling high growth, entrepreneurial start-ups. The change in focus reflects the growing recognition of these businesses as an important catalyst for competition, productivity, employment and income growth, and virtuous cycles of innovation and investment. Start-ups have also been recognised as forming an important link between R&D and intermediate and final product markets. Whilst proportions vary, start-up businesses represent a very small share of new businesses in all countries.

In recent years, the pace and variety of government efforts around the world to foster entrepreneurial start-up activity has been remarkable. For example, Singapore, the United Kingdom, the United States and New Zealand have variously introduced seed or venture capital funding programs, special visas for entrepreneurs, tax concessions for start-ups, government funded business incubator and accelerator programs, and entrepreneurship education programs in schools. However, the impact and effectiveness of government policies in this area is highly contested and the extent to which strategies can be translated and replicated successfully elsewhere and over what timeframe is questionable.

In some locations (such as in Tel Aviv and New York) the direct role of government policies in enabling entrepreneurial activity is clearly acknowledged. Yet there are also countless examples of governments attempting to engender such activity from nothing and failing spectacularly (Australia's 'multifunction polis' near Adelaide was a case in point). Equally, there are many hubs of entrepreneurial activity emerging, for example, around universities or financial districts with very little, if any, direct government involvement (such as the Level39 fin tech hub in the London Docklands).

What is increasingly being understood is the importance of the ‘ecosystem’ (in the terminology of the World Bank, the OECD, numerous governments and academia) in which entrepreneurial activity is undertaken. That ecosystems are unique and evolving over time is a key reason why replication of successes is unlikely (figure 3).

Figure 3 Entrepreneurial ecosystem



Recognition of entrepreneurial ecosystems also helps with understanding the beneficial spillovers that can be generated in, and from, a thriving and dynamic entrepreneurial community (box 1):

- the knowledge and skills from creating new products, processes and organisational forms (not generally capable of being protected by intellectual property laws) are not confined to an individual business but become available to others (businesses and investors) who can use them without bearing the costs of their creation;
- each business confers benefits on other businesses in the ecosystem — for example, by contributing to a ‘critical mass’ of start-ups needed to attract specialised support services and labour;



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- successful entrepreneurs become informed angel investors, advisors, mentors, venture capitalists, and advocates for other businesses.

### Box 1 Entrepreneur work spaces

- 1871 is a not-for-profit entrepreneurial hub for digital start-ups in Chicago. It links digital designers with engineers and entrepreneurs through a co-working space, workshops and classes, and also provides links to leading ‘business builders’, investors and mentors.
- Artisan’s Asylum is a not-for-profit community fabrication centre in Massachusetts, which promotes the teaching, learning and practising of design and fabrication. It offers shared tools and equipment, classes, space and equipment rentals, and onsite material and project storage; and hosts and promotes local craft-related events.
- Level 39 is an office space for early-stage businesses — mostly fin-tech — that have high growth potential. Co-located in the London Docklands are a cluster of bank, financial and accounting firms that interact with Level 39 businesses. Level 39 hosts innovation and accelerator programmes and regular networking events; and provides, for a fee, a drop-in space, hot-desks, fixed desks and private office spaces.
- BlueChilli is a for—profit business incubator and accelerator in Sydney, Melbourne and New York. It offers: a digital agency service for individuals to get their tech start-up business ‘off the ground’; an incubator service 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.
- The Melbourne Accelerator Program originated out of the Melbourne School of Engineering and is located near, and funded by, the University of Melbourne. The program aims to support start-ups by their students, staff and alumni by providing seed funding, office space and mentoring.
- 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.
- The recently established Stone and Chalk is a not-for-profit ‘fin-tech’ hub located near Circular Quay, Sydney. It aims to support the development of world-leading fin-tech start-ups. It offers a co-working space including desks, meeting and board rooms, events space, lounge area, and other facilities.

Many of these spillover benefits arise from informal, non-market networks that strengthen the operation of the ecosystem. Where these interdependencies or networks are missing — for example, because there are coordination or information failures between parts of the ecosystem that would be prohibitively costly for participants to overcome — the Commission has concluded there is a potential rationale for government involvement that is *supplementary* to traditional rationales that focus on failures within particular markets.

Importantly, benefits also flow to other non-entrepreneurial businesses and the wider community from this activity, through increased demand and the creation of new products, services and ideas.

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The importance and intrinsic character of entrepreneurial ecosystems suggests a more nuanced, and perhaps more limited, role for governments compared with previous policy approaches. Governments cannot create successful entrepreneurial ecosystems. Entrepreneurial activity will only be successful and self-sustaining if driven by entrepreneurs, not by governments. Likewise targeting individual elements or ‘failures’ within the ecosystem without considering the whole is likely to be ineffective at best, and potentially detrimental.

The Commission has previously outlined (in its 2015 Trade and Assistance Review) a framework for determining whether there is a role for government assistance and, if so, to guide the operation of assistance in practice. This framework identifies three phases: undertaking due diligence; the development of operational governance practices; and independent evaluation.

In the context of facilitating an ecosystems approach to entrepreneurial activity and assessing what role, if any, there is for government policy, due diligence requires first establishing that there is an entrepreneurial ecosystem of sufficient scale and quality of activity that it could drive itself to become viable and self-sustaining with only temporary and limited government support. In the absence of this, government programs seeking to support such activity are unlikely to be successful, much less lead to net benefits to the community. In order to assess entrepreneurial ecosystems, governments will need to have appropriately skilled and experienced people.

Only once it has been determined that a potentially viable entrepreneurial ecosystem exists, should governments turn to assessing what role, if any, they might have in supporting the capture of beneficial spillovers or reducing prohibitive ecosystem transactions costs. However, the existence of spillovers and prohibitive transactions costs do not, of themselves, justify government involvement. Importantly, governments should only get involved where such involvement would move outcomes of the ecosystem closer to a ‘socially optimal’ outcome (in terms of scale, quality and timing) and where there are net benefits to the community from doing so.

Governments typically struggle to determine, let alone demonstrate, what action by them, if any, is of net benefit to foster start-ups and to enable communities to capture more of the beneficial spillovers generated. The significant risk of ill-considered government action is that it can reduce incentives for entrepreneurs to compete vigorously or encourage rent-seeking behaviour from other businesses pursuing similar treatment.

In many circumstances, governments’ role is best limited to ensuring broader policy settings are consistent with aspirations for entrepreneurial activity (which also improves the operating environment for all businesses) and that unnecessary regulatory impediments are minimised. This may include addressing regulatory issues and regulator engagement practices (as discussed above), ensuring new businesses have access to markets and infrastructure, and setting standards to ensure new products and services are consistent with desired community outcomes.

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In terms of developing appropriate operational practices (in addition to the core elements of establishing measurable objectives, performance indicators, monitoring and reporting) to increase the likelihood of community wide net benefits and reduce the risk of creating distortions or perverse incentives, any direct government involvement within entrepreneurial ecosystems should:

- avoid micro-managing entrepreneurial activity, including through program criteria that prescribe particular business sizes, models, technologies or sectors;
- be modest relative to the scale of the market (to avoid distorting markets and incentives or crowding out alternative funding or activities) and require private sector ‘buy-in’ that exceeds government contributions;
- be limited in duration with a clear exit strategy established at the outset;
- be delivered by people with local knowledge, cross-sectoral skills, ability to manage and tolerate risk, and the capacity to generate or cultivate networks;
- include frequent and transparent assessment against objectives to enable early learnings to be captured and for programs to evolve or end accordingly.

Existing assistance programs for the set-up of businesses should be reviewed at all levels of government and those that do not meet these criteria should be concluded within three years.

In the Commission’s view, the need for governments to understand the specific characteristics of an entrepreneurial ecosystem would mean that any direct role for government would likely fall primarily to Australia’s state and territory governments, working in collaboration with local participants. However, all levels of government should consider the extent of their role in the development of broader framework elements that underpin entrepreneurial activity and ecosystems. The Commission considers that the following areas warrant particular consideration in this regard.

*Entrepreneurial culture:* 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. Stakeholders corroborated these views to the Commission. The Commission considers that the business sector (not just the start-up community) is likely to be best placed to foster a more positive entrepreneurial culture, including developing avenues for serial entrepreneurs (whether financially successful or not) to share their experiences with potential entrepreneurs. Government has few levers that will be effective in this space, but must ensure that any programs that satisfy the criteria above explicitly allow for, on a case-by-case basis, the inclusion of entrepreneurs who have had unsuccessful business attempts (but not as a result of malfeasance). Consistent with this, the Commission has recommended reforms to personal and corporate insolvency arrangements targeted at reducing the penalties for, and stigma associated with, business failure, that should also improve entrepreneurial culture.

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*Access to entrepreneurship and science, technology, engineering and maths (STEM) skills:* STEM skills, as well as skills in business management and marketing, and a capacity to ‘think outside the box’ are widely considered as important for workers in start-up businesses. The Commission found mixed evidence from international comparisons of deficiencies in STEM and other skills of Australian students prior to entering the workforce. What does appear to be lacking however, are opportunities in Australia for some skilled graduates to develop their training in an innovative business environment.

The importance of entrepreneurial activity and the pace with which new business models and technologies are evolving underscores the need for Australia’s education institutions and governments to remain relevant and connected to these activities to ensure Australia has access to the required skilled labour for future productivity growth. The Commission considers there is merit in governments reviewing:

- the ways the education system interacts with the business community to build better links between student skills and future careers, and any barriers to this happening;
- the capacity of university degrees to accommodate practical innovative business experience for students, and to engage entrepreneurs in teaching programs and extracurricular activities (such as seminars and guest lecture series) where relevant;
- university recruitment strategies as well as academic performance assessment and promotion policies to increase the focus on entrepreneurial capabilities and business experience.

*Access to sources of knowledge, ideas and data:* The set up of businesses (particularly those in the professional, scientific and technical services industry) is higher in regions in Australia that contain a university or publicly funded research institution. Nonetheless, Australia’s research (as evidenced by publications) has generally failed to translate into successful business opportunities. Australia ranks 9<sup>th</sup> in the OECD in publications of research undertaken, but 81<sup>st</sup> out of 143 countries for the efficiency with which it converts innovation inputs into outputs, 16<sup>th</sup> out of 17 OECD countries in terms of creating new-to-the-world innovation, and last out of 33 OECD countries on the proportion of businesses that collaborate with research institutions on innovation. There is a lack of clarity and process around industry access to university and public-body held intellectual property. Further, the current university focus on peer-reviewed research combined with a general paucity of practical industry experience amongst academics provides little incentive for academics to translate research into commercial business opportunities.

The Commission recommends the Australian Government establish a comprehensive and independent inquiry into the Australian innovation system to include an examination of the practices of government agencies, universities and publicly funded research bodies with regard to their generation and support of ‘blue-sky’ and ‘transformative’ research, their collaboration with business and establishment of business incubator spaces, and their management of intellectual property and commercialisation practices.

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Some governments in Australia and overseas release their publicly held data — such as data on transport networks, education and health systems, and environmental conditions — enabling individuals and businesses to mine the data to examine problems and explore solution options. As the Commission has noted in the past, much more could be done by Australian governments in this area. The Commission recommends all governments make data available in de-identified formats to provide opportunities for academics, researchers, and prospective and existing businesses, to explore business opportunities as innovative solutions to public policy problems. It is a major task, but also a vast unutilised opportunity.

*Access to networks:* The importance of networks in the start-up community cannot be overstated. The use of Internet and video conferencing has not replaced extensive networks of trusted relationships. These networks often make a crucial difference to getting finance from business angels or venture capital, accessing relevant advice, mentoring or suppliers and in enabling the combination of ideas and technologies in new and innovative ways. Importantly, the value of the network increases with the number of participants. In complex and fast-paced innovation environments, an absence of networks and coordination options can mean otherwise viable ideas fail to be developed into new businesses — representing opportunity costs for the broader community. For start-ups that do not otherwise have many connections in the business, legal or financial communities, business incubators, hubs and accelerators can fill this gap. While most incubators, hubs and accelerators are likely to ease the way of new micro business operators into markets, the extent of any public benefits derived from these groups remains uncertain. Given the emergence of commercially operated business incubators (as well as co-working spaces and hubs), the Commission recommends governments review their funding in this space to avoid displacing or duplicating private sector activity.

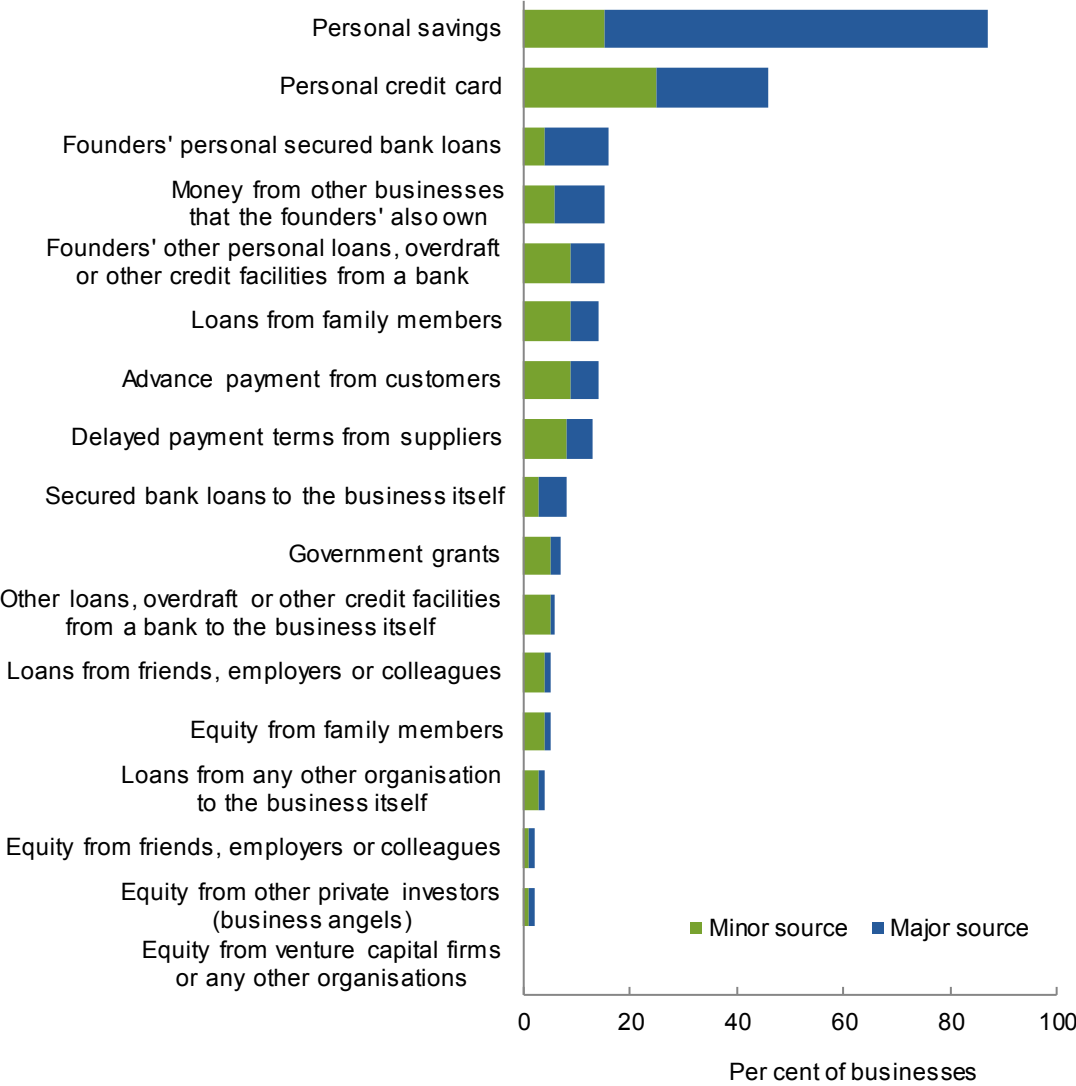
Australia's universities can be a key part of the networks for innovative new businesses. The Commission recommends that all Australian universities strengthen their use of alumni networks to foster interactions between universities and business communities, enhance employment opportunity networks and increase the scope for past graduates to financially contribute to, and draw on, university research. Deepening networks with international alumni would provide an opportunity for Australian universities to become more closely connected to global innovation and entrepreneurial networks.

## **Access to finance is not a barrier for most**

Obtaining finance can be a critical early step in starting a business. The Commission's consultations have indicated that for most businesses setting up in Australia, access to finance is not a major barrier. There are, however, a number of specific issues that need to be addressed with regulatory arrangements around some forms of financing. Further, for some of Australia's innovative start-ups (that do not yet have a proven business model or track record as an entrepreneur), access to finance can be challenging in the early stages of development.

Reflecting the fact that the vast majority of new businesses start small and deliberately remain that way, 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’) (figure 4). Funding from family and friends is also common. Of those that seek either debt or equity finance under a business name, the Commission was consistently advised that most with a credible business plan are successful.

**Figure 4 Sources of finance for nascent businesses<sup>a</sup>**



<sup>a</sup> A 'major source' of funding is defined as representing at least 20 per cent of total funding needs.

Even for high growth potential start-ups, funds from family and friends are typically relied on in the first instance, before the start-up seeks funding from government grant programs, crowd-sources, a business accelerator, or business angels. Once a start-up displays some commercial prospects, venture capital can become an option. Traditional forms of debt are

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generally not considered by start-ups because they typically do not have the cash flow to service a loan, even if assets are available to use as security.

### **Debt finance is generally available, at a price**

Banks are the primary source of debt finance and they usually require real estate as security against a business loan. Typically, around three-quarters of all micro and small business lending is secured; half to two-thirds of this lending is secured by housing. 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. Banks, governments and some professional associations provide considerable information to assist businesses develop business plans and apply for debt finance.

There is a clear gap in the traditional debt financing market in both credit type and price. For small and medium businesses with asset security, loans are typically available at interest rates of around 6-7 per cent (compared with around 5-6 per cent for home loans); for those without asset security, credit cards with interest rates of 14-20 per cent are the usual source for small amounts of financing.

However, there is no evidence of any systemic regulatory issues that would give rise to this gap in debt finance — the existence of a gap in the traditional debt financing market in Australia does *not* in itself indicate a need for government involvement. It appears that banks are reluctant to be seen to charge higher interest rates on debt finance to businesses (other than through credit cards), even to those businesses that have sufficient cash flow but little asset security. In these circumstances, credit cards represent a simple and quick — albeit blunt — way to incorporate some form of higher ‘risk premium’ in the applicable interest rates. Loan products that would fill this gap, including unsecured finance, appear to be more readily available in some other countries (such as the United States).

### **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 more stringent licensing

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requirements, monitoring by the Australian Securities and Investments Commission (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 and no case for imposing additional restrictions.

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

Comparatively few new businesses seek or use external equity finance. For some, there is no obvious suitable source of such finance. Equity financiers, such as ‘business angels’ or venture capitalists are usually only interested in investing in innovative businesses (with high growth prospects), and then often 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. The new preferential tax and regulatory arrangements for employee share schemes, effective from July 2015, should also assist liquidity constrained small businesses that are actively seeking to attract and retain skilled staff without drawing on limited funds. The Commission recommends, however, that the costs and benefits of these arrangements, and their eligibility, be reviewed within five years.

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**

For 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, to undertake other corporate restructuring or by entrepreneurs seeking to capitalise on the value in their innovative high growth business. Given the relatively fixed costs of preparing and submitting a prospectus, the costs of listing 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 averse 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



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a secondary board on the ASX with lower governance requirements for smaller listings received no support.

### Crowd-sourced equity

There has been a growing focus in recent years on increased use of crowd-sourced funding via the Internet. Often when a business seeks crowd-sourced funding it is tied to the need for funds to enable the development or commercialisation and/or production of an innovative new product that is likely to very quickly appeal to a wide range of people, but no interest (equity) in the business passes to the funder (only the promise of products or services). For example, a recently invented Australian 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.

Crowd-sourced equity funding (CSEF) allows a potentially large number of investors to make a small investment in a business or activity in return for an equity stake. At present, there are significant regulatory barriers to the development of CSEF 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, it is considering alternative settings for the size and structure of businesses that might be enabled to use CSEF, the amount of equity that could be raised, and disclosure and reporting obligations. The Commission considers that CSEF could be opened up further, while providing some protection to small investors.

In particular, the Commission recommends a regulatory framework for CSEF that allows sophisticated and professional investors to invest uncapped and other smaller ‘mum and dad’ investors to invest up to \$25 000 per year. This two-tier arrangement would increase the sources of equity funding for businesses while offering safeguards for less informed investors. It would also bring CSEF regulatory arrangements into line with Australia’s peer-to-peer lending arrangements. The Commission recommends that all businesses — whether public or private — that raise equity under CSEF arrangements should be regulated as ‘exempt’ public companies for a limited period (these businesses would be subject to initial lower reporting and disclosure requirements than public companies raising funds) and should face a \$5 million per year cap in the amount that could be raised from unsophisticated and non-professional investors. The Commission recognises that initial cap levels are somewhat arbitrary and should be adjusted in light of experience with the operation of CSEF.

### Venture capital

Australia’s venture capital (VC) sector is small, relative to that of the United States, but comparable (in terms of VC investment as a share of GDP) with Germany and New Zealand. There were around 35 VC transactions per million businesses in Australia in

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2013-14 with an average investment of around US\$1.7 million, compared with 149 per million in the United States with an average investment of around US\$9.2 million. Investment returns are highly variable.

The Commission found disparate views on the accessibility of VC in Australia and inadequate data to assess availability and demand for funds.

On the one hand, some VC funds reported that Australia has a dearth of businesses that are at an investible stage — that the value of a start-up (and therefore its attractiveness as an investment) lies not so much with the innovative idea that has given rise to the business, but rather, in a demonstrated capacity of the start-up to develop that idea on a commercial basis. The relatively small scale of VC in Australia means that smaller funds will necessarily make smaller investments across a range of businesses and potentially reduce their portfolio risk through both diversity and through lower risk investments. The Commission was advised that many VC funds take a more ‘hands on’ approach to their investments than do other capital providers and are therefore more prone to invest locally or in a known technology field.

On the other hand, many start-ups believe VC funds are relatively risk averse and have insufficient funds allocated for Australian investments. For start-ups without investor contacts or links to an incubator or accelerator, it can be more difficult to attract the initial VC investment to develop the innovative idea on a commercial basis, than it is to obtain initial seed stage funding from business angels (the Commission was advised that Australia has a prosperous network of business angels).

On balance, the Commission has concluded that high growth potential innovative businesses are likely to attract funding irrespective of their location. Businesses with a credible global focus will be more attractive to overseas VC funds and will likely need the size of the investment that is primarily possible from overseas funds. There has been a flow of VC into Australia — while it varies from year to year just under half of all new VC in 2013-14 was sourced from overseas. Where Australian entrepreneurs take their new businesses overseas, evidence presented to the Commission suggests that it is the entrepreneurial networks and final product markets, rather than the availability of VC financing as such, that are often the draw-cards.

What remains uncertain to the Commission, given the quality of data in this area, is the extent to which innovative ideas that could be commercialised are ‘lost’ (not supported in Australia or offshore) — because uncertainty, lack of idea ‘pitch’ skills in entrepreneurs or lack of understanding/insight by investment fund managers mean the ideas are not able to attract the necessary funding for further development or commercialisation in a timely way. Uncertainty and lengthy horizons until commercialisation can shift private financing away from entrepreneurial activity and early stage research toward more certain, replicative, activities. Furthermore, unintended investment incentive effects created by, for example, differential tax treatment of profits and losses, can adversely impact riskier investment opportunities, and provide a rationale for government to reduce distortions.

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The Australian Government has several tax incentive measures in place to encourage investment in start-ups. The Early Stage Venture Capital Limited Partnership program (which provided capital gains tax relief on \$37 million invested in 51 businesses in 2013-14) appears to be targeting a stage of investment funds (seed and early VC funding) where markets are less developed and its design appears not to distort investment incentives. The Commission recommends that the program should continue for now but be subject to an independent evaluation in 2017 to examine the costs and benefits for the community and the merits of extending similar capital gains tax exemptions to individual investors.

The Commission heard during the inquiry a number of claims that Australia's superannuation funds could be a source of additional VC funding. 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 VC. However, comparatively low returns on some VC investments, the relatively small investment amounts involved and the due diligence required, may make direct investment in VC in Australia an unattractive option for superannuation funds. That said, a number of entrepreneurs and two superannuation funds recently committed to establishing a fund to target those start-ups that would previously have relocated overseas to seek funding. This suggests that funds for VC are increasing without any further policy intervention.

The Commission does not support any attempt to direct the investment decisions of superannuation funds and considers that doing so would increase the risk and potentially lower the value of superannuation for Australian retirees (based on the performance record of Australia's VC 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 small proportion of businesses with entrepreneur owners, the sale of their innovative business to another may be the ultimate goal.

For the majority of cases, it is quite simple and inexpensive to cease operating a business. The efficient and timely transfer of ownership or control can be complicated by complex ownership structures, taxation issues, the transfer of leases and assets and the desire 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.

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## **Succession planning and tax simplification**

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 rapid technological change threatening the viability of some existing business models. In the case of family businesses, greater geographic dispersion of families and more diverse family structures create additional challenges.

With a decreasing proportion of business owners aged under 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 funds from the sale of these businesses may be limited — currently only 40 per cent of businesses listed for sale are 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.

The Commission considers that planning for business succession is largely a commercial matter for business owners, the next generation of owners and their business and personal financial advisors. Governments should limit their role to preparing guidelines on regulatory requirements or arrangements relevant to exit and succession planning.

The complexity of the tax system when businesses are sold or transferred as an ongoing concern — in particular, small business capital gains tax concessions — is an area that warrants government attention. The Commission recommends that the options for streamlining small business capital gains tax concession arrangements be considered through the White Paper on the Reform of Australia’s Tax System and that consideration also be given to the relationship between small business capital gains tax relief and retirement incomes policy for small business owners.

## **Insolvency arrangements need targeted reform**

Around 6 per cent of business exits involve formal insolvency — mostly of companies but to a lesser extent other business structures. By number, the bulk of insolvencies relate to small companies with small liabilities, but there are also 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. 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.

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Some companies attempt to avoid the publicity and stigma of formal insolvency processes by instead undergoing an informal confidential ‘workout’ (usually with their banks as the major secured creditors), although such an approach necessarily limits financial restructuring options to those centred on the secured creditor. Anecdotally, informal workouts have become more common.

For financially distressed companies that are unable to restructure through an informal workout, the operation of the insolvency regime (including voluntary administration, receivership and liquidation) is critical in providing an opportunity to restructure, or if that is not possible, an efficient, effective and orderly process for winding up. The regime should operate so as to not create incentives for self-serving strategic behaviour by 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 and higher returns overall through a coordinated approach; and engender confidence in the system for business owners, employees and creditors.

The Commission heard that, overall, Australia’s insolvency regime is operating well. However, flaws in restructuring processes due to risk aversion and negative perceptions, long timeframes for corporate liquidations, and (at times) disproportionately onerous reporting and appeal processes suggest that some reform is necessary.

## **Corporate restructuring processes**

### **The extent of reforms needed to Australia’s restructuring processes**

There is a perception that Australia’s insolvency regime provides insufficient focus on, or incentives to, restructure (particularly compared with US insolvency processes), and instead, puts too much focus on penalising and stigmatising corporate failure.

The Commission found that a wholesale switch toward an insolvency regime akin to that of the United States is unnecessary, unjustified and was not supported by participants in this inquiry. 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 2). 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.

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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 2      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).

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 close supervision of the Bankruptcy Court. 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 10 per cent of Australian companies undergoing restructure or insolvency have a voluntary administrator appointed (who is in control of the company). 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.

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. Specifically, the Commission recommends that in order to remain in voluntary administration (rather than be liquidated), the appointed administrators must have reasonable grounds to believe that the company (or a large component entity of it that may emerge following a restructure) is capable of being a viable business. While not guaranteeing the recovery of every company, in the long term this should reduce the stigma associated with voluntary administration.

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With appropriate checks on related party sales, provision should also be made for pre-positioned sales, whereby a non-distressed sale is organised but not completed in the period immediately prior to a formal insolvency appointment. Such sales could become more common as a result of advice given under the safe harbour defence, and specific provision could be made for their use by small business.

### A 'safe harbour' for restructure

To better support early restructures, consideration should also be given to the role and responsibilities of company directors during restructuring and the incentives these create. In particular, the Commission recommends the introduction of a 'safe harbour' defence for directors of solvent but struggling companies, such that they would be able to undertake formal restructuring activities without liability for insolvent trading while the defence is active.

The defence would require formal (but not public) appointment of a registered restructuring adviser, and receipt of advice that is proximate to a specific circumstance of financial difficulty. Should the adviser form the view that restructure into any form of viable business or businesses is not possible, they would be under a duty to terminate the safe harbour period and recommend the commencement of a formal insolvency process.

### Contract continuation during restructure

Ipsa 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. They can severely constrain the ability of a business to continue trading during restructure. The operation of these clauses can reduce the scope for a successful restructure or prevent the sale of the business as a 'going concern'. Many countries have restricted the use of such clauses.

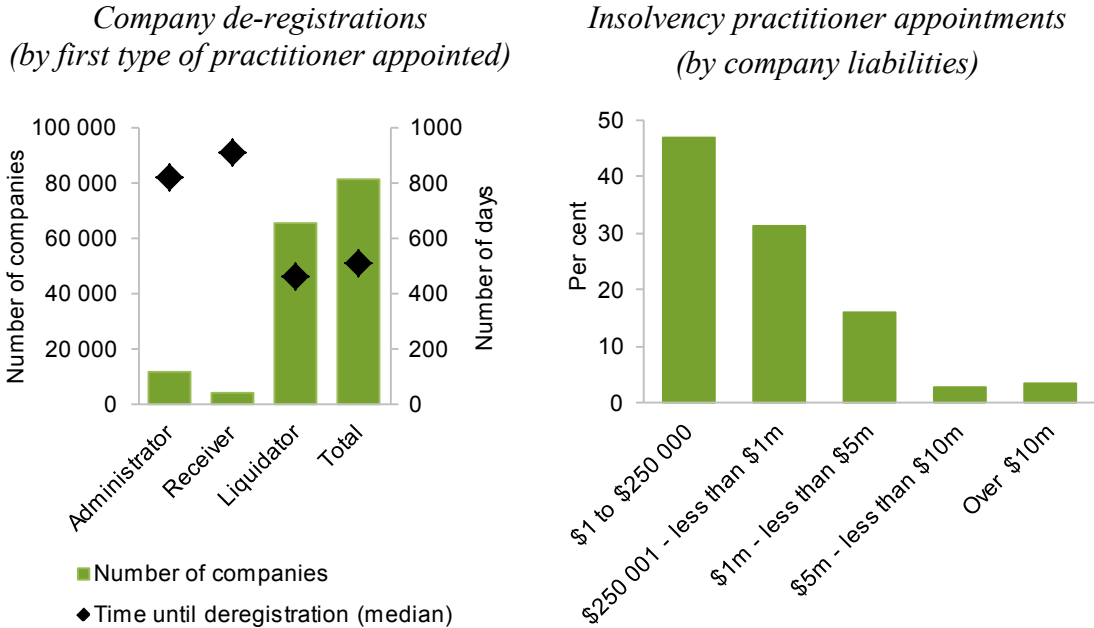
The Commission recommends that the *Corporations Act 2001* (Cth) be amended such that ipsa facto clauses are void (unless otherwise directed by a court) when a business is controlled by an administrator (as already applies if a person is in bankruptcy). This would not excuse the business from complying 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 (75 per cent) and this is also the quickest route (figure 5). The median time spent in winding up a company is around 500 days, which is comparable with or slightly above overseas 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 5 Too long is spent winding up small companies**



**A streamlined approach for small liquidations**

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. The Commission considers there is considerable scope to streamline insolvency processes for the majority of businesses through the creation of a two stream approach.

For medium and large scale liquidations that have numerous creditors involved and/or significant assets requiring redistribution, the current liquidation processes would apply (figure 6).

For micro and small liquidations (with liabilities to unrelated parties of less than \$250 000) 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 liquidator used would be drawn from an ASIC panel of approved independent liquidators formed by a competitive tender process, and their 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, detailed investigations into conduct, proof of debt, pursuit of unfair preference claims and advertising requirements would be reduced.

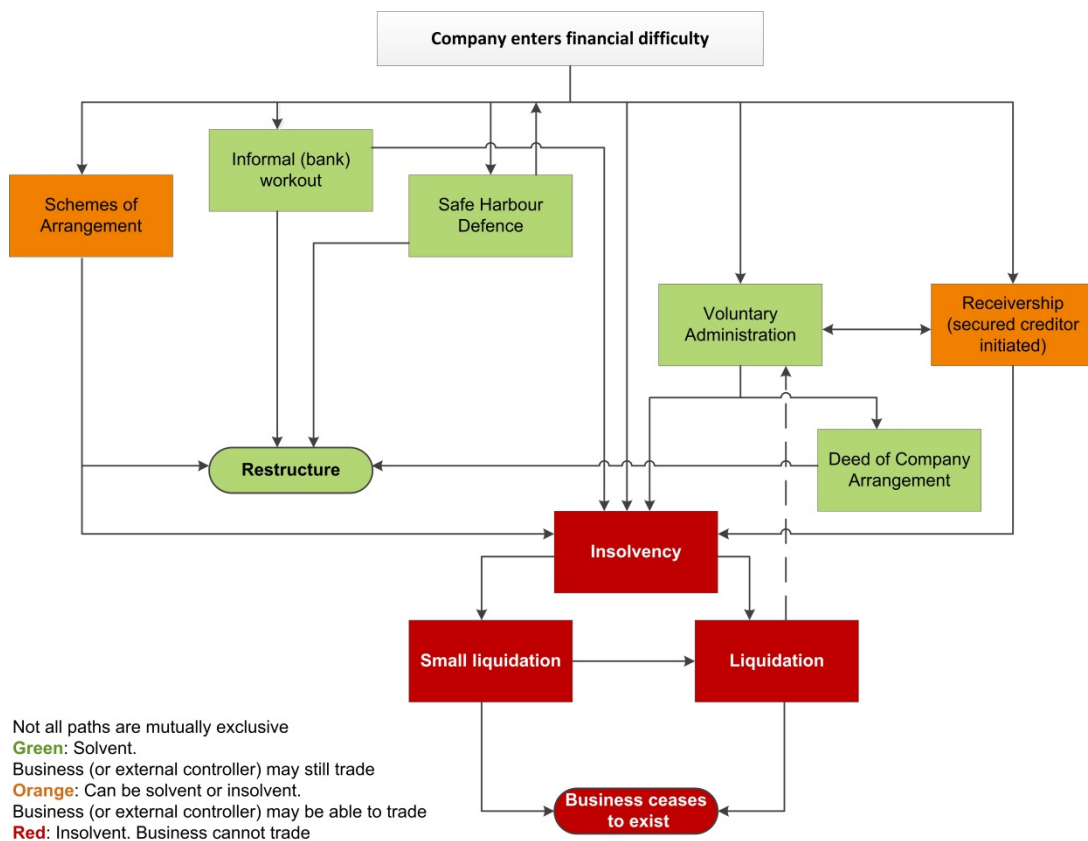


This would reduce the delay and expense from seeking court approval on matters such as remuneration, asset sales, and the degree of investigation.

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 fee (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 the tender process conducted by ASIC.

In the case of a liquidation with insufficient recoverable assets, the balance of the liquidator's fees would be reimbursed through ASIC. This function would exceed the current funding and objectives of the existing Assetless Administration Fund. Accordingly, the Commission recommends that the fund be renamed the Public Interest Administration Fund (reflecting the public rather than creditor interest in most small liquidations) and the additional revenue required be raised by increasing the annual review fee charged by ASIC on Australian company number renewals.

Figure 6 **The Commission's recommended framework for corporate restructuring and insolvency**



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## Role and power of receivers and unsecured creditors

A secured creditor currently 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 recommends that receivers be subject to improved transparency and disclosure requirements in instances where unsecured creditors form a committee for the purposes of engaging with the receiver.

## Protecting against phoenix activity

While the purpose of this inquiry is not directed at illegal 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 — it is important that reforms intended to expedite the liquidation process do not inadvertently facilitate phoenix activity. It has been estimated that around 2000 businesses per year are involved in phoenix activity, at a total cost to employees, business and governments of \$1.8 to \$3.2 billion per year.

Phoenix activity can be also associated with a siphoning of assets by business owners out of business (including 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.

There has been substantial legal and policy attention devoted to phoenix activity. Rather than the creation of new offences or agencies, the Commission has focused on improving the capacity to enforce existing laws. 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. The Commission recommends the introduction of a director identification number, underpinned by an identification process along the lines required to establish a bank account, to 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. This would be an addition to existing requirements for director information.

## 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

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and small businesses (although most bankruptcies in Australia relate to personal rather than business-induced financial distress).

The Commission has 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). The Commission considers that, where no malfeasance has occurred, the exclusion period should be reduced from the current period of 3 years down to 1 year, as has already been done in a number of other countries. The trustee and courts should retain 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. The obligation of bankrupts to make excess income contributions to the trustee would remain for 3 years or until discharge, if the period of bankruptcy has been extended beyond 3 years.

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# Recommendations and findings

## Regulatory arrangements around business set-up

### RECOMMENDATION 3.1

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 across business types
- the feasibility of a simpler entity for small business that would combine features of existing structures.

### RECOMMENDATION 3.2

Governments, particularly those at a state, territory and 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 Regulator* (2012)
- *Regulator Engagement with Small Business* (2013).

### RECOMMENDATION 3.3

Industry-specific regulations that restrict business entry and the competitive operation of markets should be reviewed or removed, as recommended in the Harper Review. In reviewing their regulations, governments should assess whether they generate a net benefit to the community and whether they are the best way of achieving government objectives.

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#### RECOMMENDATION 4.1

The extension of protections against unfair contract terms to small businesses should be reviewed within five years. The review should include examining if the provisions are being misused by businesses to avoid contractual obligations. To facilitate such a review, the Treasury should ensure that adequate data collection arrangements are in place.

#### RECOMMENDATION 4.2

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

## Regulation of new and innovative business models

#### RECOMMENDATION 8.1

All jurisdictions should provide a legislative framework for fixed-term exemptions to specific regulatory requirements that deter entry by business models that do not fit within the existing regulatory framework. Such regulatory exemptions should be disallowable instruments and subject to public review prior to expiry.

Legislative safeguards should be put in place to ensure the regulatory exemption does not lead to a material increase in the risk of adverse outcomes to consumers, public health and safety, or the environment.

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
- ensure that regulation and regulators are flexible and adaptive in the face of evolving technologies and business models and properly funded for this task.

#### RECOMMENDATION 9.1

The Australian Securities and Investments Commission, the Australian Prudential Regulation Authority and the Reserve Bank of Australia should, with appropriate industry consultation, develop an enhanced graduated framework and determine appropriate thresholds and prudential requirements for stored value facilities. The framework should be published to provide clarity to new stored value systems.

There should also be an ongoing review process or indexation of thresholds 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.

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#### RECOMMENDATION 9.2

The *Payment Systems (Regulation) Act 1998* (Cth) should be amended to require a transparent process for the assessment of applications to designate payment systems. The changes should include a formal application process; the publication of determinations and the reasons for each determination; and a review process through the Australian Competition Tribunal. The process should be similar to that for the National Access Regime set out in Part IIIA of the *Competition and Consumer Act 2010* (Cth).

#### RECOMMENDATION 9.3

The Australian Government should amend the *Anti-Money Laundering and Counter-Terrorism Financing Act 2006* (Cth) to enable the Australian Transaction Reports and Analysis Centre to regulate digital currency businesses for anti-money laundering and counter-terrorism financing purposes.

#### RECOMMENDATION 9.4

Digital 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 digital currency in both Division 195 of the *A New Tax System (Goods and Services Tax) Act 1999* (Cth) and relevant GST Regulations.

## Governments and entrepreneurial ecosystems

#### RECOMMENDATION 10.1

The creation of entrepreneurial ecosystems cannot be driven by governments. Where a self-generated nascent ecosystem exists and there are demonstrable additional net social benefits arising from proposed government involvement in excess of those that will naturally occur from the ecosystem, limited support addressing specific ecosystem deficiencies could be justified. In order to minimise the risk that government support distorts incentives within the ecosystem or fails to result in net social benefits, assistance should:

- be supported by an analysis of the ecosystem which identifies deficiencies and evidence that addressing these will improve outcomes
- avoid targeting particular business sizes, models, technologies or sectors and focus on strengthening ecosystems, including networks and connections between all participants
- be modest relative to the scale of the market and conditional on measurable private sector 'buy in' that exceeds government contributions
- have a clear exit strategy established at the outset
- be delivered by people with local knowledge and cross-sectoral skills
- incorporate frequent monitoring against clear objectives, and be subject to independent and transparent evaluation.

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All Australian governments should, within three years, review existing assistance directed at the set-up of new businesses to ensure programs — including those for start-ups, business incubators, accelerators and hubs — are consistent with the above approach. These reviews should not be conducted by agencies responsible for implementing the programs and should be published. Those programs that are not consistent with the above principles should be wound up.

#### RECOMMENDATION 10.2

To support an entrepreneurial culture, and build future skills and capacity:

- governments should use positive language to describe start-up success and failure that is associated with ‘trying again’ and ‘learning by doing’
- state and territory governments should review the ways in which schools interact with the business and entrepreneurial community and any barriers to this happening
- governments should not deny access to any assistance programs solely because an entrepreneur has had an unsuccessful business venture in the past
- universities should review the length and structure of their degrees to accommodate practical entrepreneurial experience of students
- universities should review their recruitment, performance assessment and promotion policies to ensure an increased focus on entrepreneurial capabilities and business experience.

#### RECOMMENDATION 10.3

The Australian Government should commission a comprehensive and independent inquiry into the Australian innovation system, which is to include among other aspects:

- the business collaboration, intellectual property management and research commercialisation practices of the public sector, including universities and publicly-funded research institutions
- business incubators, accelerators and hubs in universities and publicly-funded research institutions
- the public funding and provision of ‘transformative research’, including that by universities and publicly-funded research institutions.

#### RECOMMENDATION 10.4

To support access by start-ups and other businesses to publicly-funded data, governments should publicly release their data in formats that ensure privacy and confidentiality requirements are met.

#### RECOMMENDATION 10.5

Universities should review their management of alumni networks with a view to maintaining links with alumni and enhancing the contribution of successful entrepreneurs among their alumni back into their universities and local entrepreneurial ecosystems.

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## Access to finance

### 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.

### RECOMMENDATION 6.1

The Australian Government should introduce arrangements to facilitate crowd-sourced equity funding based on:

- a single corporate form (the ‘exempt public company’) — as proposed by the Corporations and Markets Advisory Committee (CAMAC) in its *Crowd sourced equity funding* report — with the ability to revert to a proprietary company where the entity meets the legislative requirements following the exemption
- the regulation of intermediaries as proposed by CAMAC, without the proposed restrictions on intermediaries having a financial interest in an issuer or on their fee structures, but with full disclosure of intermediary interests
- a regulatory framework to protect investors, including cooling off periods, acknowledgment of risk and a cap on those investors that are not ‘sophisticated’ or ‘professional’ investors as defined under the *Corporations Act 2001* (Cth)
- an issuer cap of \$5 million per year (that excludes funds raised from sophisticated and professional investors) and an investor cap of \$25 000 per year and \$10 000 per issuer as proposed in the Treasury consultation paper, but recognising that such caps are arbitrary and should be adjusted in light of experience with the operation of crowd-sourced equity funding.

### RECOMMENDATION 6.2

The effectiveness of employee share schemes and the costs and benefits to the broader community of their concessional taxation treatment should be reviewed by 30 June 2020. The review should consider:

- the use of additional tax concessions for small start-up companies and the eligibility requirements to access these tax concessions
- the removal of the cessation of employment as a deferred taxing point for equity or rights granted by an employer.

### 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.

### RECOMMENDATION 6.4

The Australian Government’s tax incentive scheme — the Venture Capital Limited Partnerships — to increase the supply of venture capital, should be closed to new registrations while the Early Stage Venture Capital Limited Partnership should continue.



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Both the Early Stage Venture Capital Limited Partnership arrangements and the ongoing Venture Capital Limited Partnerships should be subject to an independent evaluation in 2017 as to the costs and benefits of these arrangements for the overall community. The evaluation should also consider extending the provision of capital gains tax exemptions for individual investors.

If the Government intends to continue to provide tax incentives for venture capital following this evaluation, future arrangements should be:

- back-ended to reward success and avoid tax minimisation
- limited to seed stage or early stage venture capital, where there are likely to be greater difficulties in accessing capital
- subject to an independent evaluation as to the overall costs and benefits after the scheme has been in place for an adequate period.

#### FINDING 7.1

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.

#### 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.

#### RECOMMENDATION 7.2

Australian governments should not pursue credit guarantee schemes as a means of enhancing the ability of new businesses to access debt finance.

#### RECOMMENDATION 7.3

Governments should cease programs that offer concessional loans to new businesses on the basis of their location or industry.

For concessional loan programs provided to new businesses as a means of addressing social disadvantage, clear and persistent economy-wide net social and economic benefits should be able to be demonstrated. In the absence of these benefits, these programs should also cease.

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## Voluntary business exits

### RECOMMENDATION 11.1

In line with recommendations from the Harper Review, the Australian Competition and Consumer Commission should combine the formal merger clearance process and the merger authorisation process, and remove unnecessary restrictions and requirements to improve the efficiency and effectiveness of business transfer processes.

### RECOMMENDATION 11.2

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 relationship between small business capital gains tax relief and retirement incomes policy for small business owners.

### RECOMMENDATION 11.3

Governments should confine their involvement in business succession planning to raising the importance of this issue publicly, ensuring the provision of high quality, accessible information on relevant regulatory issues, and ensuring government processes are as timely and inexpensive as possible with appropriate cost recovery.

## Business restructuring

### FINDING 13.1

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

### FINDING 13.2

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.

### RECOMMENDATION 14.1

The *Corporations Act 2001* (Cth) should be amended such that, for an administration to continue, within one month of appointment the administrator must certify they have reasonable grounds to believe that the company (or a large component entity of it that may emerge following a restructure) is capable of being a viable business.

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If the administrator is unable to certify this, they should be under a duty (enforceable by the Australian Securities and Investments Commission) to convert the administration into a liquidation.

#### RECOMMENDATION 14.2

The *Corporations Act 2001* (Cth) should be amended to allow for a safe harbour defence to insolvent trading. The defence would only be available when:

- directors of a company have made, and documented, a conscious decision to appoint a safe harbour adviser with a view to constructing a plan to turnaround the company
- the adviser was presented with proper books and records upon appointment, and can certify that the company was solvent at the time of appointment
- the adviser is registered and has at least 5 years' experience as an insolvency and turnaround practitioner
- directors are able to demonstrate that they took all reasonable steps to pursue restructuring
- the advice must be proximate to a specific circumstance of financial difficulty, and subject to general anti-avoidance provisions to prevent repeated use of safe harbour within a short period.

The defence would not attach to any particular decision and instead would cover the running of the business and any restructuring actions from the time of appointment until the conclusion of (reasonable) implementation of the advice.

- If the adviser forms the opinion that restructure into any form of viable business or businesses is not possible, they are under a duty to terminate the safe harbour period and advise the directors that a formal insolvency process should commence.

The safe harbour adviser may only be appointed in a subsequent insolvency process with leave of the court.

#### RECOMMENDATION 14.3

Provision should be made in the *Corporations Act 2001* (Cth) for 'pre-positioned' sales.

Where no related parties are involved, there should be a presumption of sale such that administrators can overturn sales only if they can prove that the sale was not for reasonable market value (in accordance with s420A of the Act), or if it would unduly impinge on the performance of the administrators' duties. Administrators or liquidators should be allowed to rely on the pre-appointment sale process as evidence.

If sales are to related parties, there is no presumption favouring sale and the administrator's or liquidator'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.

In both cases, s439A of the Act should be amended to include requirements to disclose information of the sale to creditors.

Where the sale (whether given effect before or after the insolvency appointment) is the result of advice received under the safe harbour defence, that defence should also apply against voidable transactions actions from administrators or liquidators.

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#### RECOMMENDATION 14.4

The small liquidation process detailed in recommendation 15.1 should include provision for small pre-positioned sales, consistent with recommendation 14.3.

In the context of small businesses, the requirements of s420A of the *Corporations Act 2001* (Cth), and investigations of related parties, should be applied proportionately in relation to determining the relevant market for the sale, advertising effort and reasonable price.

#### RECOMMENDATION 14.5

The *Corporations Act 2001* (Cth) should be amended such that *ipso facto* clauses that have the purpose of allowing termination of contracts solely due to an insolvency event are unenforceable if the company is in voluntary administration or the process of forming a scheme of arrangement. Amending legislation should make clear that the party experiencing the insolvency is in no way absolved of any other contractual obligations.

External administrators should be given the ability to apply to the Court to require continued performance of a contract where the Court is satisfied that the supplier is attempting to avoid this moratorium, and that the continuation of the contract is in the best interests of the creditors as a whole.

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.

#### RECOMMENDATION 14.6

The *Corporations Act 2001* (Cth) should be amended to create a moratorium on creditor enforcement actions during the formation of schemes of arrangement. This should be aligned with the approach used in voluntary administration.

Courts should also be given the explicit power to lift all or part of the moratorium in circumstances where its application would lead to unjust outcomes.

## Corporate insolvency

#### RECOMMENDATION 15.1

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 to unrelated parties of less than \$250 000.
- To access small liquidations, directors should be required to lodge a petition to the Australian Securities and Investments Commission (ASIC) and verify that their books and records are accurate.
- The primary role of the liquidator would be to ascertain the funds available to a reasonable extent, given a reduced timeframe. Requirements for meetings, reporting and investigations should be reduced accordingly.

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- The pursuit of unfair preference claims should be limited to those within three months of insolvency and of material amounts. The duty to pursue unfair preferences should be explicitly removed unless there is a clear net benefit and it will not impede conclusion of the liquidation.
  - Creditors would be able to opt out of the process and into a standard creditors' voluntary liquidation, and ASIC would be able to initiate further investigation if it has concerns of illegality.

Liquidators for these processes would be drawn from a panel of providers selected by tender to ASIC. Panel membership would be for a period of up to five years, with ASIC able to conduct tenders at regular intervals to ensure that demand can be met.

ASIC should be empowered to hear complaints of practitioner misconduct and if the complaint is upheld, replace the liquidator. ASIC should be enabled to take disciplinary action, if warranted, against the discharged liquidator, including the suspension from participation in the panel or revocation of their registration.

#### RECOMMENDATION 15.2

In instances of small liquidations where a liquidator is unable to recover funds to cover their own fee, and where the Australian Securities and Investments Commission (ASIC), is satisfied that the activities are not excessive, the liquidator should be able to apply for the balance of their fees to be paid through ASIC.

- The existing Assetless Administration Fund should be renamed the Public Interest Administration Fund and its objectives and funding modified to reflect this new function.
- To the extent that this requires additional funding, it should be raised by increasing the annual review fee for company renewals.

Funding should also be available from the Public Interest Administration Fund in instances where ASIC initiates further investigations beyond those required by the small liquidation process.

#### RECOMMENDATION 15.3

The Australian Government should instigate an independent review, to report by 30 June 2017, of the relevant parts of the *Corporations Act 2001* (Cth), and the practices of receivers in the market, with a view to ensuring that:

- The primary role of the receiver should be to protect the value of the property that is the subject of the secured credit.
- The focus should be on the performance of individual loans. The appointment of receivers should not be used as a mechanism to manage lenders' portfolios.
- If there is a substantial group of unsecured creditors affected by the receivership, the receiver should have consideration of the impact of their actions upon the overall wellbeing or insolvency of the company.

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#### RECOMMENDATION 15.4

The *Corporations Act 2001* (Cth) (the Act) should be amended such that where the stakeholders in a receivership (that is, unsecured creditors including employees and government authorities such as the Australian Taxation Office) form a committee of inspection and notify the receiver, that committee should have the right to basic information regarding the receivership process. This should include, but not be limited to:

- a description of the proposed process
- the results of the sale process
- details of proposed and actual costs and disbursements.

Receivers should be compelled to have regard to the views of the committee in a similar manner to liquidators under s479 of the Act. Considerations directly relating to protecting the value of the security should override any views of the committee.

The committee should have standing under s425 of the Act to apply to the Court to seek relief in relation to the fees (but not actions) of the receiver.

#### RECOMMENDATION 15.5

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. As part of this, consideration should be given to amendments to the *Corporations Act 2001* (Cth) to allow the Commonwealth to play a more active role as a creditor.

#### RECOMMENDATION 15.6

In addition to existing requirements for directors, section 117 of the *Corporations Act 2001* (Cth) should be amended to require that, at the time of company registration, 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 identity proof (based on the personal identification requirements for opening a bank account), and verify that they have read brief materials on directors' legal responsibilities provided as part of the online registration.

For existing companies, directors should be required to obtain a DIN. The DINs should 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.

There should be no lessening of the existing recording of, and means of accessing, director information.

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#### RECOMMENDATION 15.7

Following the implementation of the Commission's proposed reforms to the insolvency system, the Australian Securities and Investments Commission (ASIC) should produce a Regulatory Guide targeted at small businesses facing financial difficulty.

The guide should cover legitimate restructure and liquidation options and responsibilities, with a focus on the new processes designed to assist small businesses.

ASIC should consult with the Australian Small Business Commissioner (or its successor), representatives of small business and the insolvency and legal professions in producing the guide.

### Personal insolvency

#### RECOMMENDATION 12.1

The *Bankruptcy Act 1966* (Cth) should be amended so that, where no offence has occurred, a bankrupt is automatically discharged after one year. Specifically, this should apply to restrictions relating to overseas travel, holding an office under the *Corporations Act 2001* (Cth), employment within certain professions and access to personal finance.

The trustee, and the courts, should retain the power to extend the time until the bankrupt is discharged for a period of up to eight years if there are concerns regarding the bankrupt's conduct. Any extensions should be recorded on the National Personal Insolvency Index.

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.

#### RECOMMENDATION 12.2

The obligation of bankrupts to make excess income contributions to the trustee should remain for three years. The period of excess income contributions can be extended at the discretion of the trustee to up to eight years. If the period of bankruptcy is extended beyond three years, then excess income contributions should be required until discharge.





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# 1 Context of the inquiry

## 1.1 Inquiry background

To strengthen Australia's international competitiveness, 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 notes that entrepreneurship and business start-ups promoted employment creation and productivity growth. These types of businesses benefit the broader economy by testing new ideas, developing new products and implementing new models for operating (Australian Government 2014d).

In announcing this inquiry, the then 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 highlighted that Australian business may be falling short of its innovative and entrepreneurial potential due to policy barriers (Featherstone 2014). There is also a view that, in comparison to other countries, Australia lacks the necessary start-up ecosystems to foster new and innovative businesses.

At the other end of the business life-cycle, there is seen to be scope for improvement in Australia's insolvency arrangements to facilitate business restructuring or closure, the redeployment of assets and to encourage more entrepreneurial activity.

## 1.2 Inquiry scope

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, introduce a new process or operating model, put competitive pressures on existing businesses and may provide spillover benefits to other parts of the economy. Most, however, provide familiar products and services in ways very similar to those firms they compete with or that operate in other places.

Many 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

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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. Finally, whilst those few new businesses that are truly innovative and have high growth potential are clearly motivated by the prospect of significant equity returns, a desire to ‘change things’ is a common characteristic of their founders.

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 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.

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; government grants and subsidies to businesses; 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 this report, the Commission has conducted its own analysis and drawn heavily on input from participants through consultations, public hearings 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?**

For the purposes of this inquiry, a business is considered to be an entity (for profit or not-for-profit) that actively trades products 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 or close. 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.

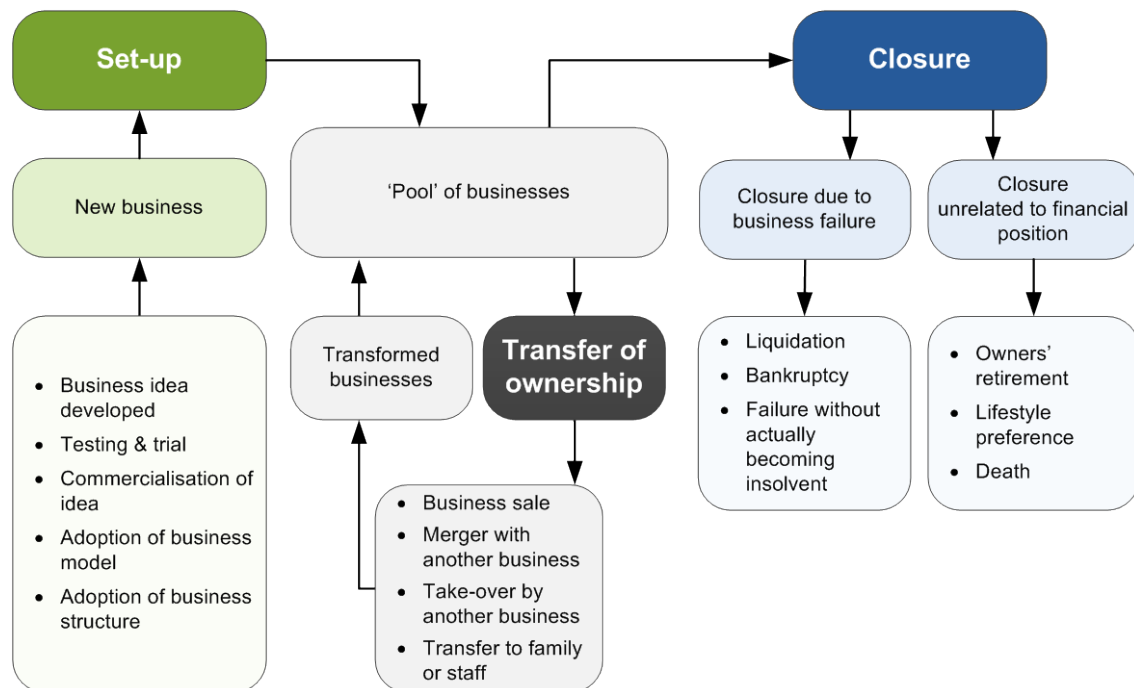
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## What is meant by set-up, transfer and closure?

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.

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



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- *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 general regulation, access to finance, digital business models, access to payments systems and government assistance.
  - *Transfer* — a change in business ownership. There are various degrees of change in ownership — a business may be completely sold, merged with another business or transferred to family members or associates. A transferred business 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

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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.

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

New businesses benefit the economy in a range of ways. Set-ups introduce new products and services that 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 improve the range, price and quality of products and services, offer alternative methods of provision, and expand the number of market participants.

Business closures — particularly failures — involve costs that can be highly visible. This includes the personal impact on business owners and employees, the social impact on the regions affected, 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 1.1).

There is no doubt that there are significant costs associated with business failure and in some instances considerable personal hardship for those involved. But it is important to acknowledge the somewhat less visible, but still important, role business closures play in a market economy by enabling the reallocation of less productively used resources and contributing to longer term economic growth, living standards and entrepreneurial learning.

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### Box 1.1 **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 and considerable financial and stress-related pressures. Many thousand more people in associated industries were also substantially affected. 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 Australian 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 (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). Specifically, thirty eight companies in the Ansett group were deregistered in May 2014. The Deed of Company Arrangement for Ansett Australia Limited remains on foot and is expected to be completed in December 2017.

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).

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## **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 2013c, 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:

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. (sub. 29, 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).

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.

The transfer and closure process also facilitates changes in the structure of the economy as the demand for, and the cost of supplying products 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 that 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 that 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

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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. The process of creative destruction has occurred (and continues to occur) across all sectors of the economy. For example, the development of the Internet and the ability to communicate via email, video calling and social media have replaced traditional communication technologies and 3D printing is emerging as a technology that will change the way some products are manufactured. These innovations have, and will, benefit consumers through higher quality products and increased convenience.

### **There can be flow-on effects to other businesses**

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). Previous set-up experience is particularly important in high tech industries (Gompers et al. 2010) — in 2014 over 40 per cent of Australian start-up founders had previously been involved in another start-up (Startup Muster 2015). 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).

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## Some business set-ups address broader social objectives

Business set-ups can also have important social benefits. While businesses are typically thought of as being motivated by profit, the desire to benefit the broader community and generate income for the disadvantaged has led to the development of social enterprises by ‘social entrepreneurs’. Ashoka (2015), an international social citizen organisation, defines social entrepreneurs as:

... individuals with innovative solutions to society’s most pressing social problems. They are ambitious and persistent, tackling major social issues and offering new ideas for wide-scale change ... Rather than leaving societal needs to the government or business sectors, social entrepreneurs find what is not working and solve the problem by changing the system, spreading the solution, and persuading entire societies to move in different directions. (p. 1)

In addition to the provision of services to the disadvantaged, social enterprises operate in traditional for-profit industries and benefit the community by employing people from diverse backgrounds and by procuring particular products. For example, a number of social enterprises in Melbourne have established cafés that purchase coffee beans made from sustainable sources and hire migrants who have recently arrived in Australia.

## 1.4 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 (such as retail) 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 requirements 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 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



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- 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).

Other reviews that may also be relevant include the current Senate Standing Committee on Economics inquiries into Digital Currency (released in August 2015), Australia's Innovation System (due October 2015), Cooperative, mutual and member-owned firms (due to report in November 2015) and Insolvency in the Australian Construction Industry (due to report in November 2015); and the current Joint Committee on Corporations and Financial Services inquiry on the impairment of customer loans (due to report in March 2016). Also of relevance is the statutory review of the *Anti-Money Laundering and Counter-Terrorism Financing Act 2006* (Cth) being conducted by the Attorney-General's Department, which is scheduled to conclude in late 2015.

The Commission is also aware of the draft 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. Also of relevance to this inquiry is the Tax and Superannuation Laws Amendment (Employee Share Schemes) Bill 2015 (Cth) that seeks to make changes to the existing tax treatment of employee share schemes and the current work by The Treasury on developing a regulatory framework for crowd-sourced equity funding. There is also the Treasury Legislation Amendment (Small Business and Unfair Contract Terms) Bill 2015 (Cth) that proposes extending unfair contract protections to small business contracts. Finally, the Commission considers that the forthcoming 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 inquiry report.

## **Data availability**

The Commission has drawn on a wide range of data sources for this inquiry but has also identified a number of areas in which basic data is unavailable including:

- *start-ups* — there are a lack of data focused on newly created innovative businesses with high growth potential and/or high growth objectives.
- *business age* — although there are data on the exit and entry of businesses and their survival rates, there are a lack of publicly available data on the age of businesses in Australia.
- *venture capital* — data on venture capital activity are often included with private equity activity and there is no information collected on those companies that were unsuccessful in attracting venture capital investment.

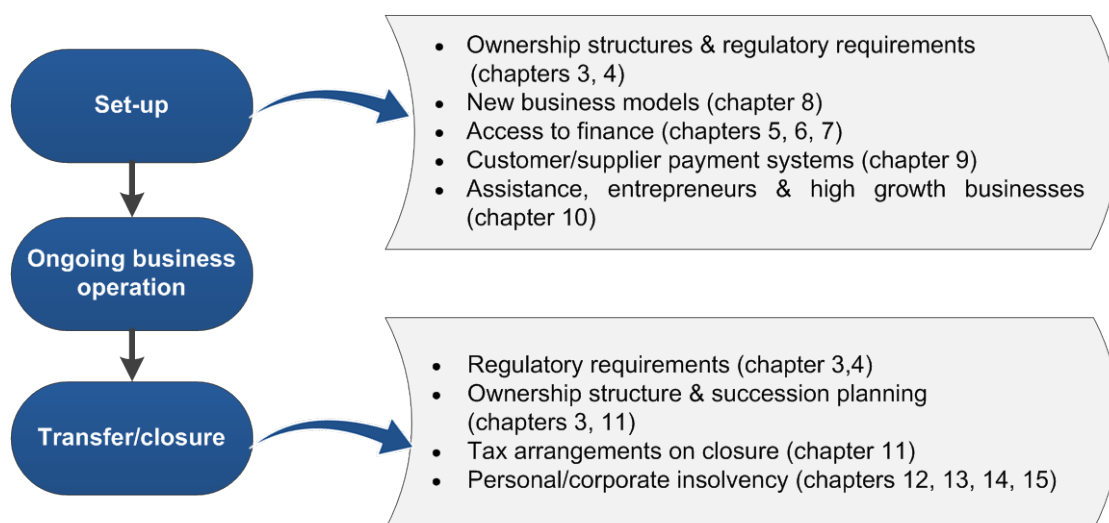
- *insolvency* — there is a lack of detail as to the circumstances of a company’s failure on the returns submitted to the regulator by external administrators. Data aggregation and analysis on corporate insolvency is hindered by the use of a non-electronic formats for some corporate insolvency returns (Anderson et al., sub. 1).
- *program evaluation* — there are inadequate data to assist in, and coming out of, the evaluation of government programs and schemes including data on businesses which benefit from tax concessions or government grants.

The existence of quality data would assist regulators and policy makers in identifying changes and trends in business set-up, transfer and closure as well as the performance of the current regulatory and legislative arrangements.

## 1.5 Guide to the inquiry 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, recent trends in business set-ups, transfers and closures and key drivers of these are discussed in chapter 2. Chapters 3 to 7 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. Chapters 8, 9 and 10 consider innovative new business models (including in business payments systems) and the nature of the business ecosystem that best encourages and supports these models. The closure of businesses — through transfer, personal insolvency (bankruptcy) or corporate insolvency — is examined in chapters 11 to 15. The appendixes cover the inquiry processes (appendix A) and provide further detailed data (appendixes B to F) to support the chapters.

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



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## 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 (fewer than 20 employees) and almost 70 per cent had no employees.
- In recent years, there has been a downward trend in entries and exits as a proportion of all businesses. The majority of closures are unrelated to financial failure, reflecting the owners' lifestyle preference or the closure of the business without insolvency – albeit sometimes in anticipation of poor financial prospects.
  - A similar decline in set-up and closure rates is evident in many OECD countries. However, Australia's set-up rate is high and its closure rate moderate, compared with many other OECD countries.
- Small businesses account for over 99 per cent of all set-ups and closures. Entry and exit rates are higher for small businesses. Not surprisingly, new businesses have a lower chance of survival than already established businesses.
- Large businesses (with more than 200 employees) have made the greatest contribution in recent years to growth in economic activity and employment.
- Not all new businesses are high growth potential, innovative 'start-ups' and business ownership is not synonymous with entrepreneurship. Indeed, start-ups are a minor portion of all new businesses. Entrepreneurs are known for their greater risk appetite and ability to innovate and create new business opportunities (often repeatedly).
- Few new businesses in Australia are innovative in terms of delivering new products or processes to international or Australian markets, notwithstanding the fact that most businesses cite no market barriers to undertaking innovation. Small businesses are less likely than larger businesses to undertake ground-breaking innovations.
- The set-up, transfer and closure of businesses are fostered or hindered by the existence and interaction of a number of factors (for example: structural, regulatory, cultural and financial) that together make up a business ecosystem. For new and innovative high growth potential businesses, the effective operation of these ecosystems are a necessary condition for successful business creation and growth.

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## 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.

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) that actively trades goods and services.

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

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.

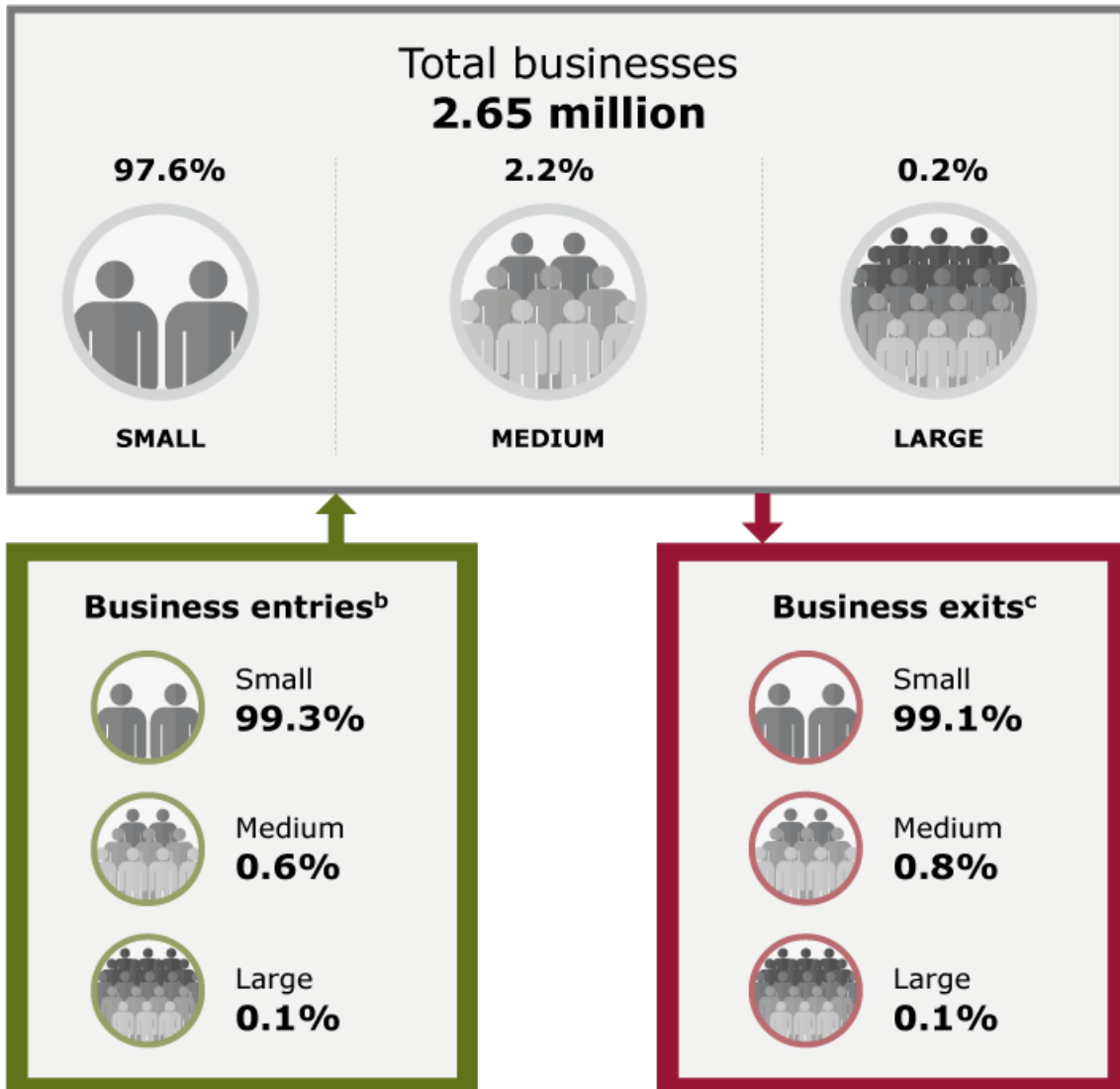
In contrast, the Australian Bureau of Statistics (ABS) understates the number of businesses, by only counting for-profit businesses registered for the Goods and Services Tax (GST). Businesses operating in the non-market sector, such as charities and sporting clubs, are also excluded. Many not-for-profit 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 issues 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 non-GST registered businesses 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 had no employees (figure 2.1).

Figure 2.1 **Businesses in Australia<sup>a</sup>**

2013-14



<sup>a</sup> 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 trade 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 and non-GST registered businesses. <sup>b</sup> Entries refer only to ABS measures and include business set-ups, reactivations and businesses that have recommenced trading during 2013-14. <sup>c</sup> Exits refer only to the ABS measure and include closures and businesses that have stopped trading during 2013-14.

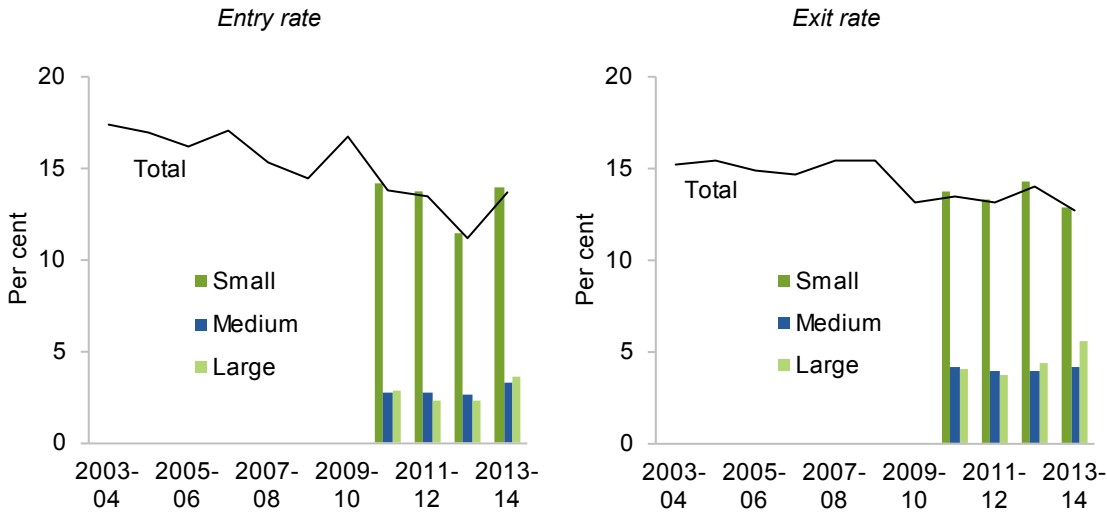
Source: Productivity Commission estimates based on ABS (2015d) and ATO statistics

While small businesses as a group are a substantial employer, job creation by small businesses has been substantially lower than that by medium and large businesses over the past six years.<sup>1</sup> Large businesses have also made the greatest contribution to economic growth over this period (ABS 2015b).

Thousands of businesses enter and exit the economy every year. In 2013-14, the number of businesses in the economy increased, as entries exceeded exits (appendix B). 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 formally becoming insolvent (AFSA 2014c; ASIC 2014e). There are a range of reasons why a business closes other than financial failure. While information is limited, the unsuccessful launch of a business idea and the resumption of work as an employee are commonly cited reasons for business closure (ABR 2014b).

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<sup>a</sup>, by business size<sup>b</sup>**



<sup>a</sup> 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. <sup>b</sup> 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, 2015d)

<sup>1</sup> The ABS employment and output shares by business size are only publicly available for the non-financial sector to 2013-14 (appendix B).

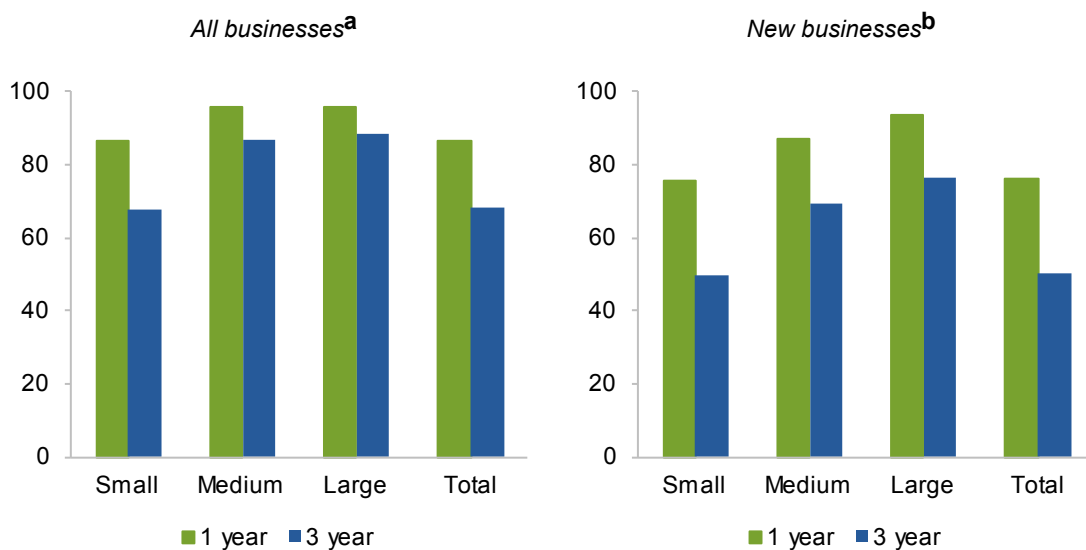
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## Small businesses make up the majority of entries and exits

Small businesses account for over 99 per cent of all entries and exits. The rate of entry and exit generally declines with entity size and is around three times greater for small businesses than for larger businesses. Business survival is lower for new businesses and those businesses that stay small (figure 2.3). Over the last decade the survival of new businesses has increased slightly ABS (2007).

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



<sup>a</sup> All businesses that were operating at the start of 2010-11. <sup>b</sup> All businesses that were set-up or recommenced trading in 2010-11.

Source: ABS (2015d)

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## 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 (see chapter 3 for more detail on business ownership structures). Over the last four years, entry rates for companies and trusts have consistently exceeded exit rates. It is the opposite picture for sole traders and partnerships. Business survival is lowest for sole traders and increases as the business structure becomes more complex.

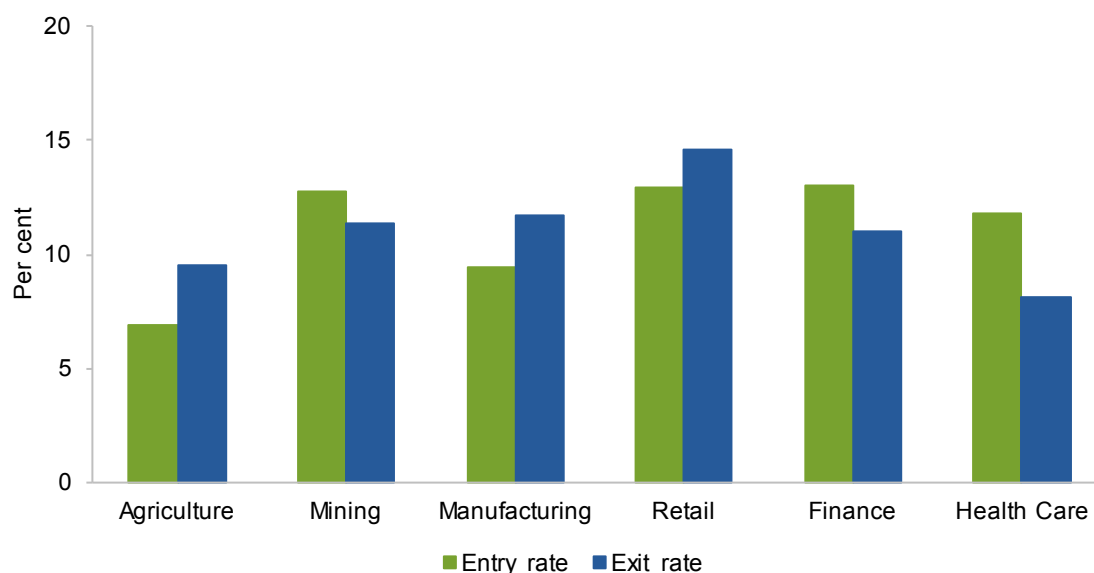
Reflecting the diversity of the Australian economy, business entry and exit rates vary between industries. Over the last four years, the number of businesses grew most strongly in the services sector of the economy, particularly in health care and finance. The largest declines were in the primary and secondary industries of agriculture and manufacturing, while business numbers increased in the mining industry (figure 2.4). Sole traders operate

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across all industries, whereas partnerships are more common in agriculture and trusts are particularly prevalent in finance (superannuation funds and investment vehicles).

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**Figure 2.4 Business entry and exit rates, selected industries<sup>a</sup>**  
2010-11 to 2013-14



<sup>a</sup> Average of entry and exit rates between 2010-11 to 2013-14.

Source: ABS (2015d)

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## How entries and exits vary with broader economic conditions

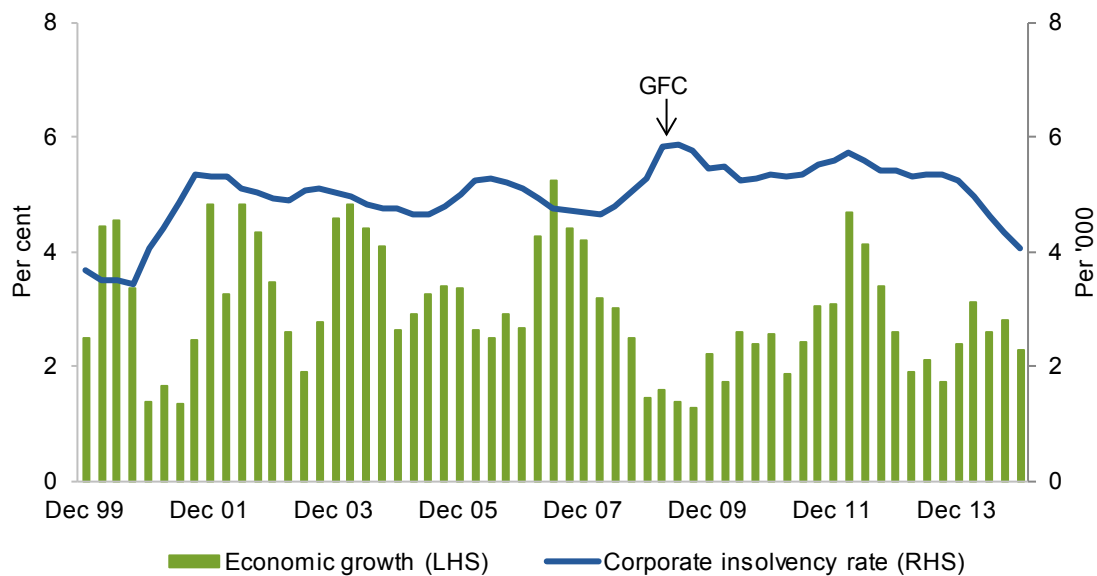
Macroeconomic conditions and population changes, along with broader government policy settings that influence the business cycle, can have an overarching influence on business set-ups, transfers and closures. These factors are largely beyond the control of a business owner and can impact on specific 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 (figure 2.5). Corporate insolvencies have shown a counter-cyclical tendency in Australia — that is, insolvencies rise when general economic activity and income growth slow (Connolly et al. 2015). The rate of corporate insolvencies peaked in 2008 following the onset of the global financial crisis (GFC). Similarly, broader macroeconomic conditions influence company survival — policy settings aimed at curbing inflation have been shown to have an adverse effect on company survival in Australia (Buddelmeyer, Jensen and Webster 2010).



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 2.5 Economic growth and the rate of corporate insolvencies<sup>a</sup>**  
Dec 1999 to Dec 2014



<sup>a</sup> 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 (2015c); ASIC (2014b, 2014d)

The relationship between business set-ups and economic growth is less clear. Lower demand during a recession can inhibit the establishment of new businesses, leading to a pro-cyclical pattern (Bernanke and Gertler 1989; Rampini 2004). However, higher unemployment during an economic downturn has been shown to drive the set-up of businesses as those unemployed seek to generate an income (Parker 2009; Thurik et al. 2008). A recent study concluded that set-ups in 109 countries have shown pro-cyclical tendencies between 2002 and 2012 (Klapper, Love and Randall 2014).

Population growth changes — either a change in the national rate of growth or shifts of population between areas — influence the rate of business set-up, transfer and closure by shaping consumer demand and the number of potential entrepreneurs entering the market. The degree that regional population growth influences the rate of business set-up and closure has varied between countries and time periods. In the United States, strong population growth during the 1970s was associated with higher levels of business formation at the end of the decade (Hathaway and Litan 2014). In Australia, regional entry and exit rates have generally moved in line with broader economy-wide factors between

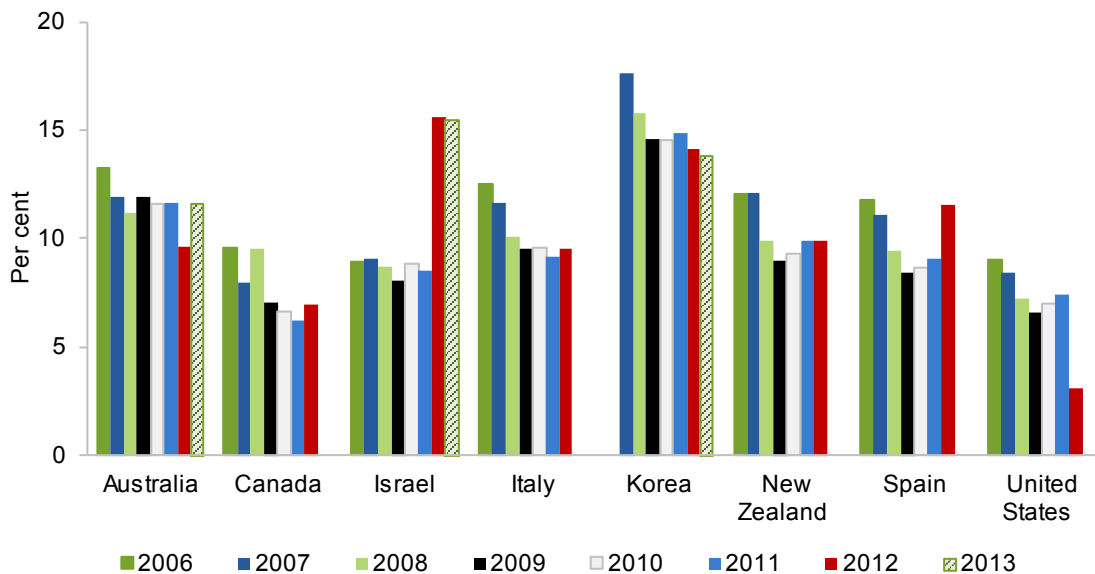
2008 and 2012. Despite this, regions that have undergone strong population growth, such as redeveloped inner city areas, have experienced higher rates of business set-up.

## How does Australia compare on entries and exits?

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. Korea has had the highest entry rates (albeit, the data includes non-employed businesses), while Israel, Canada and the United States had lower rates than Australia. The rate of business formation in Australia appears relatively flat compared with the general decline in many other countries (figure 2.6).

Figure 2.6 **Entry rate for employing businesses, selected OECD countries<sup>a,b</sup>**



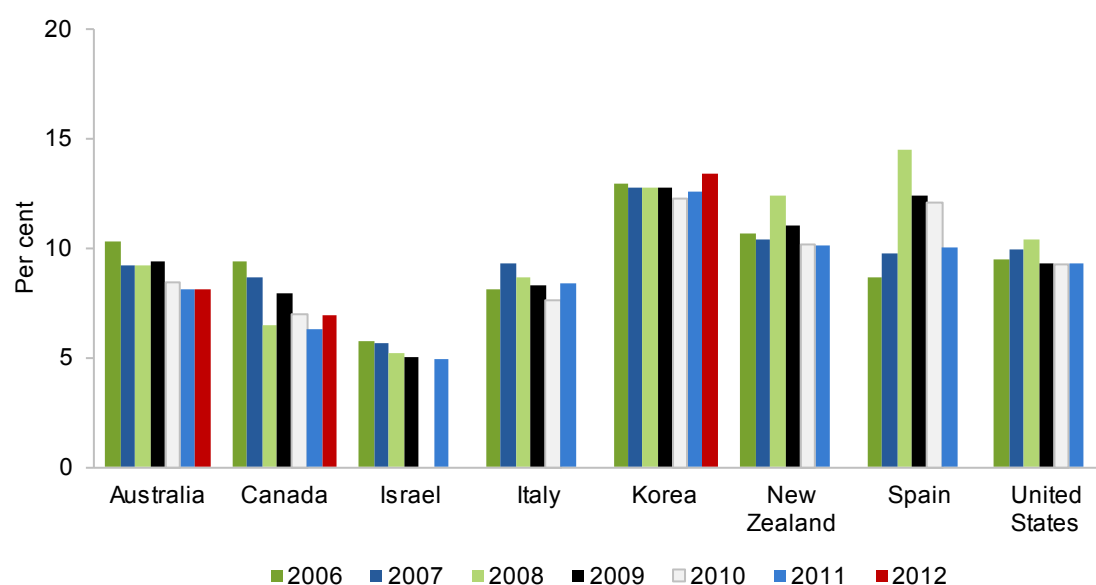
<sup>a</sup> The entry rate for employing businesses refers to the set-up of a business with at least one employee as a proportion of all active businesses with at least one employee. It does not include mergers, split-offs or restructuring of a set of businesses. International comparisons based on employing businesses have been found to be more relevant than indicators using all businesses because results are sensitive to the coverage of business registers. <sup>b</sup> Data for Korea includes non-employed businesses.

Source: ABS (2007, 2014d); OECD (2013a, 2014a, 2015a)

Australia also has a higher rate of company establishment than most other developed nations. The ‘new business density’ measure published by the World Bank (2014) shows that company registrations relative to the working age population in Australia were around two times higher than those in Israel, France and Korea between 2004 and 2012. Australian registration rates were similar to those in the United Kingdom and lower than New Zealand. Whilst ‘new business density’ is not a perfect indicator of business formation — some companies are established to manage financial assets and others may never commence trade — this does support the broader evidence suggesting that Australia has a relatively high set-up rate.

Australian employing businesses have similar rates of closure compared with other OECD countries. Those countries with high entry rates, such as Korea, also had high exit rates. 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 have increased in some other countries (figure 2.7).

Figure 2.7 **Exit rate for employing businesses, selected OECD countries<sup>a,b</sup>**



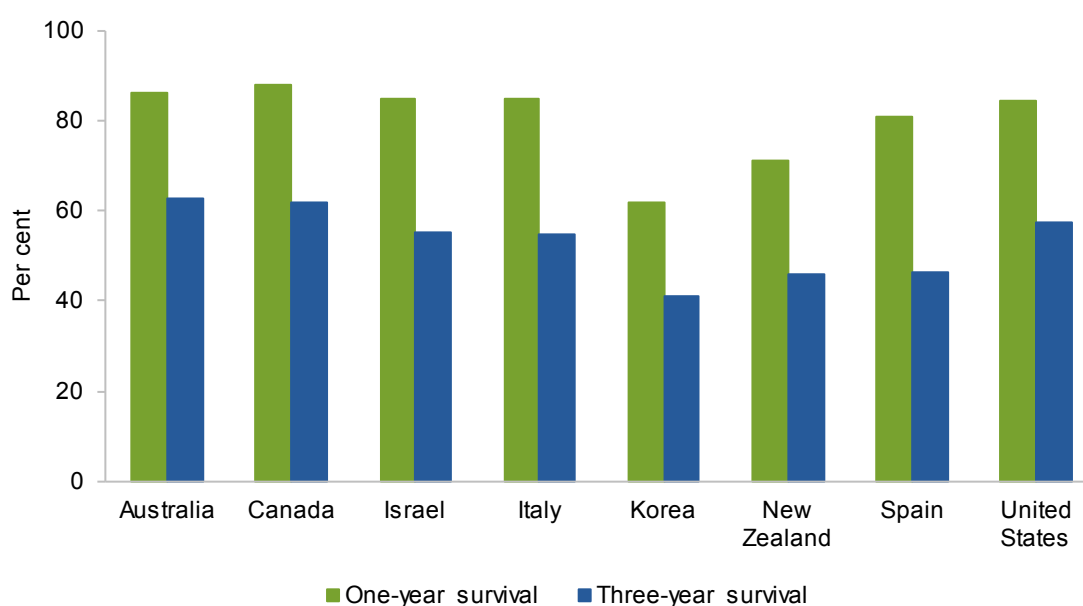
<sup>a</sup> The exit rate for employing businesses refers to the closure of a business with at least one employee or the contraction of the business to have no employees as a proportion of all active businesses with at least one employee. It does not include mergers, split-offs or restructuring of a set of businesses. For Australia, business exits are not considered to have occurred when the business changes from having employees to no employees. <sup>b</sup> Data for Korea includes non-employing businesses.

Source: ABS (2007, 2014d); OECD (2013a, 2014a, 2015a)

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 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 2.8).

**Figure 2.8 New business survival rates, selected OECD countries<sup>a, b</sup>**  
2007 to 2009



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

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

## 2.2 Few businesses are innovative and have high growth potential

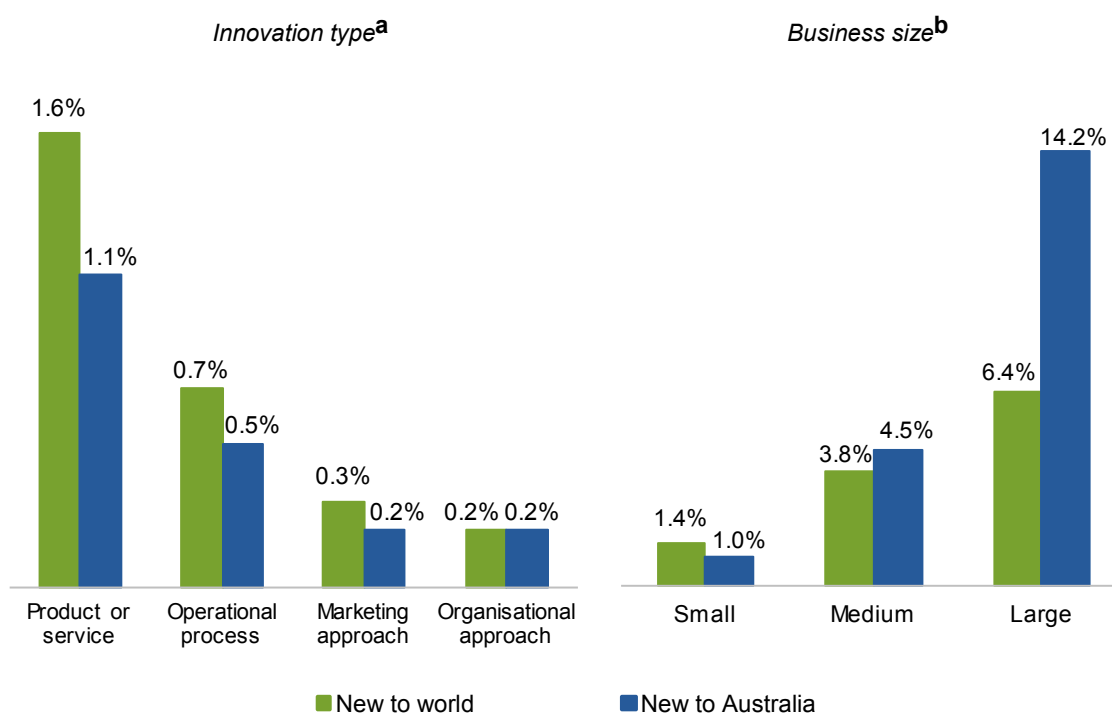
As noted in chapter 1, businesses are set-up for a range of reasons — including to provide employment for the owner and their family or to satisfy a lifestyle choice. Reflecting these differences in purpose and owners' aspirations, new businesses can be characterised as either:

- *Replicative* — new businesses operate in the same manner as other businesses already actively trading. Changes in products or processes undertaken by the new businesses are adoptive in nature as the business incorporates previously introduced products or processes. Most businesses operating in the economy and a larger share of set-ups are replicative, with few or no employees (ABS 2015d).
- *Innovative* — businesses substantially change the current operation of existing markets or establish a completely new market by adapting and originating new products, services or processes. The adoption and implementation of these ideas by replicative

businesses plays an important role in driving efficient business processes and economic growth.

Only a small proportion of Australian businesses are innovative. The vast majority of businesses are adopting product or process ideas that have already been introduced by other businesses in the market — in fact, Australia is viewed internationally as a particularly fast adopter of technology. The Commission estimates that less than 2 per cent of businesses (new and existing) introduced a product that was ‘new’ to the world or Australia in 2012-13.<sup>2</sup> Operational process or marketing method innovations were even less common (figure 2.9). Meanwhile the protection of intellectual property rights through patent applications was sought by a very small proportion (0.1 per cent) of businesses — below the reported rate of new to the world innovations.

**Figure 2.9 Few businesses are truly innovative**  
2012-13



<sup>a</sup> Proportion of actively trading businesses that introduced a new product or service that is new to the world or Australia. <sup>b</sup> Proportion of businesses in each category that introduced a new product or service that is new to the world or Australia.

Source: Productivity Commission estimates based on ABS (2014f)

<sup>2</sup> Rates of innovation are based on ABS (2014f) innovation estimates for employing firms. Non-employed 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. See appendix B for an in-depth discussion of the Commission’s innovation estimates.

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A similarly small proportion of *new* businesses are likely to be innovative. For example, knowledge based ‘high tech’ set-ups accounted for around 0.4 per cent of all business entrants (StartupAUS 2014).

Small businesses are much less likely than their larger counterparts to undertake and introduce ground-breaking innovations. In 2012-13, around 6 per cent of large businesses reported having introduced a product or service that was new to the world, compared with 1 per cent of small businesses. This disparity between small and large businesses increases for product innovations that were new to Australia.

Despite this, small businesses have an important role as innovation adopters — accounting for over 80 per cent of all adoptive innovations (new to the industry or business only) in 2012-13. The uptake of previously introduced products, services and processes facilitates the diffusion of new ideas and efficient business practices across the economy. Successful innovations are dependent upon early adopters. Rogers (2003) estimates that the take-off point for an idea happens when 10-25 per cent of the population have embraced the innovation — significantly greater than the proportion of truly innovative businesses.

The extent of innovation in Australian businesses is low both in absolute terms and relative to that in other countries. Business owners’ aspirations and the nature of the business (self-employment or independent contractor) are likely to explain the lack of innovative activities rather than market or structural barriers. Over half of all businesses in 2012-13 reported facing no market or structural barriers to introducing or implementing an innovative product or service. Access to finance and the lack of skilled persons, within the business or more broadly, were the most commonly identified barriers for both innovative and replicative businesses (ABS 2014f).

Internationally, similar innovation surveys show that Australia’s rate of innovative activity (for implemented, ongoing and abandoned innovations) is lower than some other comparable countries. Based on the most recent data, Australian innovation levels were above Norway and France, comparable with New Zealand and Canada, but lower than the United States, United Kingdom and Denmark (Cornell University 2015).<sup>3</sup> Comparing innovation rates with New Zealand, which are collected on a similar basis, shows that Australian businesses were more likely to undertake product or organisational process innovations, while improvements to marketing methods was less common. Despite the similarities between the two countries, overall business innovation in Australia may actually be higher than that in New Zealand after adjusting for scope differences (Statistics New Zealand 2012, 2014).

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<sup>3</sup> International comparisons are limited by differences in definitions, methodology, population size and collection methods. For example, some countries may include process or product adoption in their definition of ‘innovative’.

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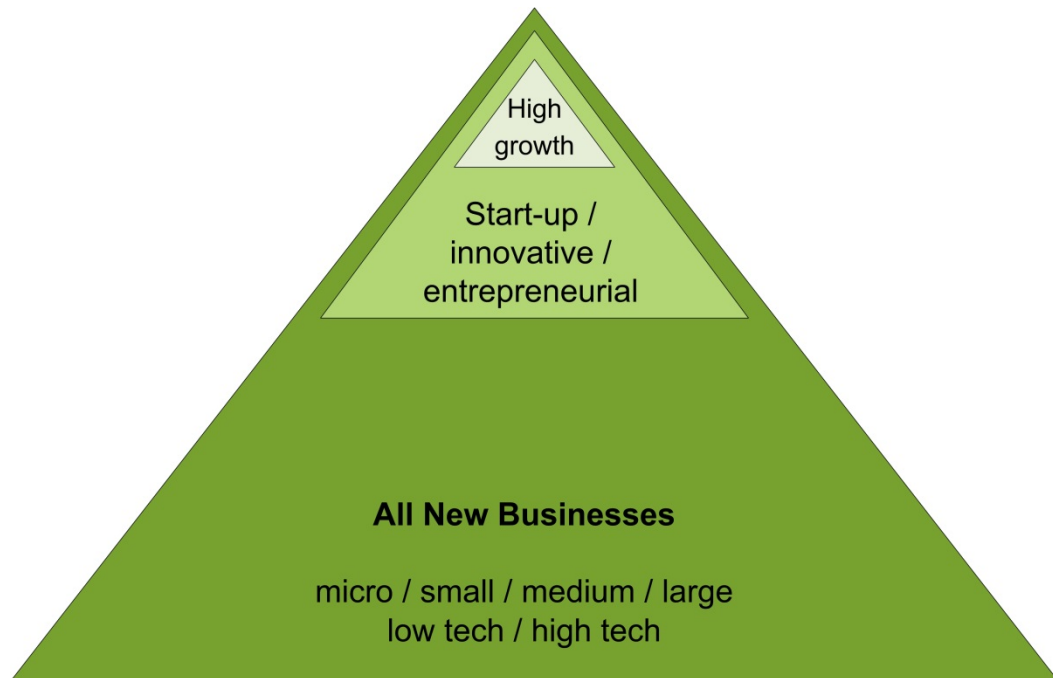
## Most new businesses are not ‘start-ups’

The term ‘start-up’ is used differently by different groups. For the purposes of this inquiry, ‘start-ups’ are defined to be those newly created businesses which are ‘innovative’ or ‘entrepreneurial’ (in that they introduce a product or process that is new to Australia or the world).

Central to this definition is the distinction between a start-up and other newly established businesses — while most start-ups begin as a small business, not all new small businesses are a start-up (figure 2.10).

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Figure 2.10 **Characterisation of new businesses**



A start-up is characterised, in particular, by the motivation and ambition of its founders to develop a business model that has the ability to grow very quickly (in terms of number of customers or revenue), but also to bring about significant market change. In contrast, a small business owner often implements a well-known business model in an established industry in order to generate (stable) profit and long term value for themselves and their family (Forbes 2012). Other descriptions often associated with start-ups include:

... an organization formed to search for a repeatable and scalable business model. (Steve Blank, serial entrepreneur)

... a human institution designed to deliver a new product or service under conditions of extreme uncertainty. (Eric Riles, author of ‘The Lean Startup’)

... a company working to solve a problem where the solution is not obvious and success is not guaranteed. (Neil Blumenthal, cofounder and co-CEO, Warby Parker)

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Consistent with only a small proportion of Australia's stock of businesses being innovative, StartupAUS (2014) estimates that there are around 1000 start-ups in Australia, which represents less than 0.05 per cent of the broader business population. The low growth intentions and the replicative nature of most new businesses has been observed by Hathaway (2013) in the United States:

Few new businesses will ever grow substantially or innovate. In fact, most nascent entrepreneurs actually report having no desire to build high-growth businesses. Instead, they intend to provide existing services to an existing customer base, and the decision to form a new business is driven more by non-economic reasons than on whether to grow a business or create a new market. (p. 3)

Start-ups are not exclusive to technology-based industries: digital start-ups are only a sub-set of all start-ups. Nor is the tag of being a 'start-up' something that a business permanently holds. A start-up is temporary in a sense that once the business model has been proven, the function of the business turns to delivering outcomes and expanding the model (or being taken over by a larger business). For example, following its rapid expansion and numerous capital raisings, Uber is no longer considered a start-up.

Although little entry and exit data are available for start-ups,<sup>4</sup> anecdotal evidence suggests business transfer via acquisition or merger is likely to be more common amongst start-ups and often is a reflection of success rather than failure. The Commission understands that start-up founders often plan and actively seek business transfer once the business model has been proven.

### **A small proportion have high growth ...**

Few new businesses grow rapidly to become large businesses — start-ups rarely succeed but when they do, their growth can be spectacular. Extremely fast growing businesses (with revenue growing by a conservative estimate of at least 20 per cent annually) are often termed 'gazelles'. Those start-ups that reach a value of at least \$1 billion are termed 'unicorns'.

Start-ups that are able to grow rapidly typically have two defining features:

- *Scalable* — the business has the potential to grow revenues significantly faster than costs. A scalable start-up has a fixed cost structure that remains relatively stable as business size and sales grow.
- *Repeatable* — the business can reapply its product or process many times. For example, selling your house is not a repeatable business model (as it cannot be sold more than once), while operating an online service that lists properties on the behalf of others is repeatable (Forbes 2014).

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<sup>4</sup> ABS business entry and exit data makes no distinction between start-ups and other forms of businesses.



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Not surprisingly, the very small proportion of businesses that are high growth start-ups have a substantial influence on job creation and the broader economy (box 2.2). 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 low proportion, this group have contributed substantially to net job creation through rapid growth and expansion (Clayton et al. 2013; OECD 2013a).

While the evidence for Australia is limited, high growth businesses have some defining characteristics. These businesses, have, in the recent past at least, been largely product based and operate in so called ‘high tech’ industries. High growth businesses also have a greater propensity to seek external finance, are more successful in receiving finance and have higher prospects of survival than the more traditional (largely replicative) businesses (Gordon and Davidsson 2013).

The owners of high growth 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 business owners are also more likely to work as a team through a joint venture rather than as an individual (Gordon and Davidsson 2013).

### **Box 2.2      Employment generation by start-ups**

An Australian study (Hendrickson et al. 2015) found that, although employing a small fraction of the Australian workforce (15 per cent), young small to medium enterprises (aged 0 to 5 years) made the highest contribution to net job creation in Australia (40 per cent), with new businesses (aged 0 to 2 years) responsible for most of this growth. The research also found that a very small fraction (3 per cent) of the micro new businesses (with fewer than 9 employees) grow dramatically over five years after entry and these businesses accounted for the majority (77 per cent) of total post entry job creation of all micro new businesses.

Other examples of the job creation benefits of high growth potential businesses are given by the Kauffman Foundation (Kane 2010, cited in StartupAUS 2015, p. 11), Meehan and Zheng (2015), Morretti (2012, cited in StartupAUS 2015, p. 11), OECD (2015a, pp. 70–75), PricewaterhouseCoopers (PwC 2013), the UK National Endowment of Science, Technology and the Arts (NESTA 2009). While the long-lasting contribution of these high growth businesses remains positive, some of their success fades overtime and some of the initial jobs created cease to exist (Davila et al. 2015).

## **Innovation and uncertainty influence business survival**

A business that undertakes innovation faces some uncertainty as to whether the development will be successful — this influences business survival. Successful innovations are likely to drive growth and increase business survival, while businesses that

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do not innovate may have a lower chance of survival. Recent Australian evidence broadly supports these tendencies. Survival rates were lower for companies that were in the process of developing a new to the world product or process and subsequently increase following the successful implementation of the innovation (Buddelmeyer, Jensen and Webster 2010). Similarly, Comprehensive Australian Study of Entrepreneurial Emergence (CAUSEE) results suggest that innovative businesses and those self-identified as ‘high tech’ (both nascent and young) have slightly higher rates of survival (Gordon and Davidsson 2015).

## **2.3 Who owns and operates Australia’s businesses**

Around 2 million Australians own and operate a business. 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 2015d).

### **Most business owners are not entrepreneurs**

Just as not all new small businesses are ‘start-ups’, not all business owners are considered to be ‘entrepreneurs’. Entrepreneurs are distinguished by their capacity to be innovative and appetite for taking risks, rather than simply establishing another business that replicates other existing businesses.

When discussing what it takes to be an entrepreneur, Mike Cannon-Brookes, Atlassian co-founder, noted how entrepreneurs are typified by their determination to change markets:

Part of an entrepreneur’s job is to change the world in some way. You don’t do that by adopting someone else’s world view. You just never really know until after you make a decision if their idea or yours was a better plan. (Powell 2015b)

An extensive body of literature attempts to sketch a profile of personal characteristics that typify an entrepreneur. Commonly cited personal traits include: initiative and the ability to perceive opportunities, persistence and a concern for quality work, self-confidence and assertiveness, and the capacity to foster relationships (Hanival 2009). Assessments of these traits has shown that ‘conscientiousness’, ‘openness’, ‘extraversion’ and ‘emotional stability’ are positively related to entrepreneurial intention and activity (Brandstaetter 2010).

Similarly, a range of studies have set out to examine the ability of education and training programs to teach and develop entrepreneurial capabilities. The link between entrepreneurial education and the level of entrepreneurial activity is considered to be fairly modest (Fairlie, Karlan and Zinman 2012; Martin et al. 2013), but is dependent on content and the manner of delivery (appendix E).

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## Business owners tend to be older than the broader workforce

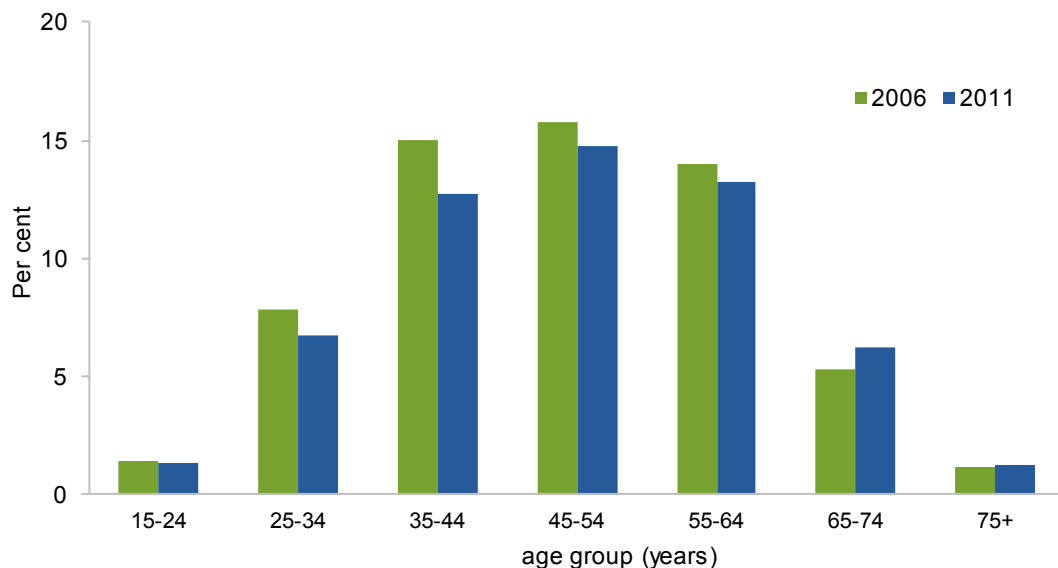
The prevalence of business ownership varies with age. In 2011, levels of business ownership were highest for those aged between 45 to 54 years. The average age of Australian business owners (at 47 years), is above the average age of the broader workforce (40 years) and has increased by one year between 2006 and 2011, compared with no change in the broader workforce over the same period.

Levels of business ownership have increased amongst those over the traditional retirement age of 65 years, with nearly one in ten business owners now beyond 65 and another one in five within 10 years of the retirement age (figure 2.11). The vast majority of the population over 65 are retired and are no longer in the workforce (ABS 2013a).

Although 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 (chapter 11).

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Figure 2.11 **Business ownership rates, by age<sup>a</sup>**



<sup>a</sup> Business ownership as a proportion of the population in each age group.

Source: ABS (2013a)

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### Owning a business at a young age is uncommon

Owning a business at a younger age is relatively uncommon and, between 2006 and 2011, became less common. On average start-up founders are younger than regular business owners — most are in their late twenties or early thirties, while only 3 per cent are over 55 years (Startup Muster 2015).

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Most young Australians undertake further study rather than operate a business or engage in entrepreneurial activity. Recent data suggest that around 60 per cent of those aged 15-24 years were involved in formal study (ABS 2014e). Business ownership substantially increases following the peak in university enrolments by 20-24 year olds.

The Foundation of Young Australians (FYA) indicated to the inquiry that around 8 per cent of 18–24 year olds undertake early stage entrepreneurship<sup>5</sup> (sub DR56, p. 4).<sup>6</sup> The FYA also commented that new business activity by younger Australians was lower than that in the United States. This may reflect relatively higher university and training enrolments by younger Australians.<sup>7</sup>

### **Business owners are likely to be male**

A higher proportion of men than women tend to run their own business, but this is slowly changing.

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 years owned a business in 2011, twice the rate of female business ownership (figure 2.12). 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).

While females have lower rates of business ownership, the number 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) (Startup Muster 2015). Reflecting lifestyle preferences and employment patterns in the general workforce, a majority of female business owners work part time in the business.

Australian business owners come from all cultural backgrounds and have varied education levels (see appendix B for further information on business owners).

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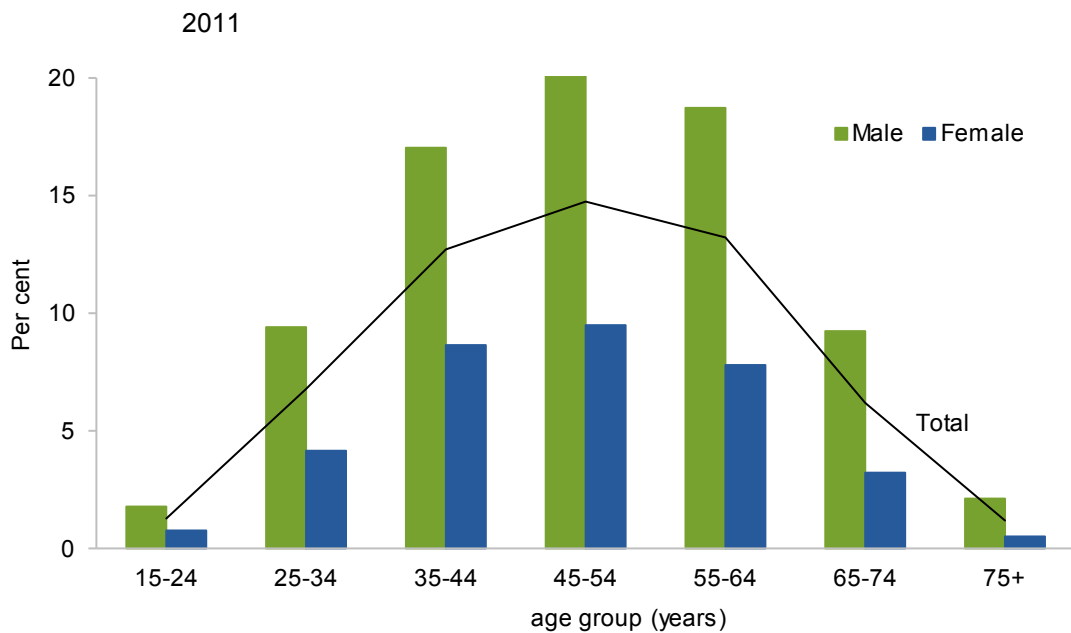
<sup>5</sup> Early stage entrepreneurship, as measured by the Global Entrepreneurship Monitor, includes those in the process of starting a venture and those running a business less than 3.5 years old (Singer, Amoros and Arreola 2015). This is a much broader definition of ‘entrepreneurship’ than is generally used in discussion of start-ups.

<sup>6</sup> This is noticeably higher than business ownership rates reported in the ABS Census of Population and Housing. These differences are likely explained by the more detailed scope of the survey questions, which includes those who are considering a business venture (rather than just those who already own a business) and by sampling error (the early stage entrepreneurship results were based on a random sample of just 2177 Australians, around 0.01 per cent of the population).

<sup>7</sup> Australian enrolment rates are higher than the United States for those aged 15-19 (87 and 81 per cent respectively) and 20-29 (35 and 27 per cent respectively) (OECD 2015b). Similarly, a smaller proportion of Australian youth are recorded as ‘not in employment, education or training’ than that in the United States (OECD 2015d).

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Figure 2.12 **Male and female business ownership rates, by age<sup>a</sup>**



<sup>a</sup> Business ownership as a proportion of the population in each age group.

Source: ABS (2013a)

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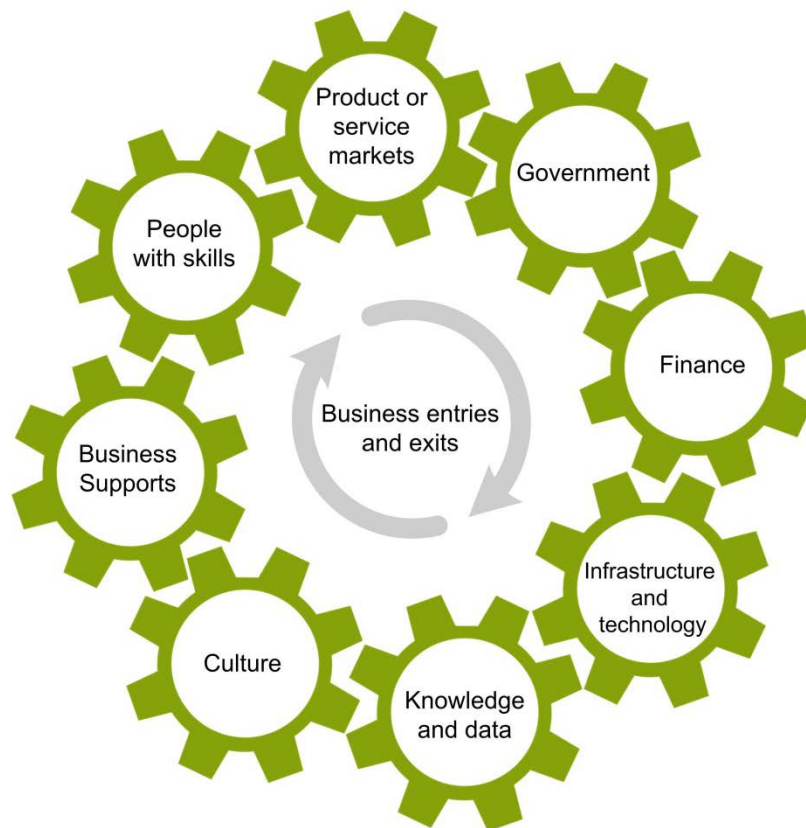
## 2.4 What drives business set-up, transfer and closure?

Setting-up, transferring or closing a business is a major decision for the owners or potential owners of a business. Along with personal considerations (such as the desire to work for one's self, to commercialise an idea, or to stop working altogether), these decisions are influenced by the existence and interaction of a number of broad components related to government policy and regulatory frameworks, product and input markets, ease of access to finance, and the cultural environment and business support networks that exist.

Together, these components make up a business 'ecosystem' — an environment that fosters or hinders the creation and survival of businesses (figure 2.13). The components in these ecosystems interact and each has a role to play. Where one factor is weak or missing, business establishment, growth and survival may be less than what would otherwise be achievable and/or be confined in the types of activities that are possible. Some ecosystems are linked and some players (such as a government or university) operate in multiple ecosystems. How extensive an ecosystem is and the types of businesses that it includes will vary between locations. A large city may have multiple ecosystems — each clustered around a particular locality, source of knowledge/ideas, or industry. In practice, many locations fail to have all the components necessary for even one viable ecosystem.

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Figure 2.13 **Business ecosystem**



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For the vast majority of businesses that are small and replicative, some aspects of the ecosystem may be largely irrelevant. For example, a new retail franchise may be unaffected by the ease of access to equity markets, the availability of R&D, or the existence of business accelerators. However, for new and innovative high growth potential businesses, the successful operation of these ecosystems, the simultaneous existence of the components and their interaction, are necessary (but not sufficient) conditions for the creation and survival of start-ups. The business ecosystems necessary to foster start-ups are usually termed ‘entrepreneurial ecosystems’.

There is extensive literature on the importance and role of various players (governments, industry, universities and communities) in building and sustaining entrepreneurial ecosystems, and this is discussed further in chapter 10. How some of the key components of business ecosystems drive business entries and exits more generally are discussed below.

***Government regulations and policies*** can both enable and impede business set-up, transfer and closure. For example, certainty and predictability of regulations, and policies that are well targeted, can make set-up easier, as the benchmark for operating the business is clearly defined. However, excessive regulatory requirements (beyond those necessary to achieve regulatory objectives) or requirements that are highly prescriptive can have the opposite effect. Complex registration and regulatory requirements have been shown to

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reduce the number of new businesses (Ciccone and Papaioannou 2007; Klapper, Love and Randall 2014).

However, governments also set standards and establish systems for property right protection — including through patents, trademarks and copyright. These protections may encourage business establishment (and innovation), to the extent that the protection of law is needed to develop or commercialise an innovation or idea. However, restrictive intellectual property rights may also prevent the establishment of new businesses. A recent study undertaken by IP Australia concluded that innovation patents have had no effect on the rate of entry or exit between 2001 and 2013, but that survival increases when the business has a pending patent (Johnson et al. 2015).

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.

**Physical and technological infrastructure**, such as for communications, transport, logistics and energy, are a part of the expected landscape that enables the operation of every business. Increasingly, technologies (such as the internet and smart phones) are accelerating entrepreneurial processes by reducing the fixed cost and capital requirements traditionally associated with setting-up and operating a business.

The establishment of a business can supplement the owners' lifestyle or other employment far more readily now than in the past. 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, greater accessibility of technology such as the internet in homes, combined with economic and lifestyle considerations, has given rise to entrepreneurial mothers ('mumpreneurs') and increased the rate of female business ownership in recent years.

Technology also means that the potential market of a business set-up is no longer restricted by location or geographic boundaries — a product or service can be sold to anyone with internet access. As Google noted (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)

This has also led to the emergence of new business models to better meet consumer needs, increase capital/labour utilisation and/or lower prices. Some of these models have challenged existing regulatory arrangements (chapter 8).

**Finance** — Setting up a new business entails costs (such as inventory, inputs, office space or staff) which, depending on the scale of the business and the resources of the owners, may

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necessitate external finance. For example, a start-up seeking rapid expansion will likely have a greater reliance on external finance than a more traditional small business. Issues around the access of new businesses to finance are discussed further in chapters 5, 6 and 7.

***Product and input markets*** — Competition and the structure of the markets in which businesses are operating can have a substantial influence on the ease of setting-up, and decisions on transfer or closure. While most industry structures are beyond the control of governments and arise because of geographic and demographic factors, some (such as retail pharmacies) are the direct result of government policies which restrict the locations and/or number of businesses.

Final product and intermediate markets that have sophisticated consumers or input purchasing businesses can provide scope for new businesses to set up that exploit a competitive advantage in meeting consumer or business needs.

***Support networks*** — Depending on the nature of the business, there can be a diverse mix of intermediaries (industry associations, government agencies, and business advisory groups) that provide information and support to businesses at different stages of their development but particularly at set-up (appendix E). Some new businesses are able to access business incubator or accelerator programs and/or make use of business mentors. In Australia, surveyed new businesses are more likely than not to report attending start-up events and consulting with mentors. Relatively few reported participating in business incubators or accelerators, but those that do state that their programs can improve product quality and reduce the time to market (Startup Muster 2015).

***Culture*** — Community attitudes to business ownership, employment security, wealth accumulation, 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, particularly innovative start-ups (chapter 10 and appendix E). In such an environment, individuals are likely to be more willing to take risks, seek to develop new products and services and commercialise ideas. In practice, attitudes to risk and innovation vary between different segments of a community and between individual businesses.

***Knowledge and data*** — For businesses that are developing an innovative idea into a commercial product, ready access to existing knowledge and data can be crucial to business establishment and growth. This can include research and data held in universities or public research bodies or other intermediaries who translate and diffuse research and knowledge from one organisation to another. In some sectors, this may include a global dimension, particularly given the small scale of such activity in Australia.

***Workforce skills, training and education*** — Access to workers with the appropriate skills, training and education is essential for the successful establishment of any business. Barriers to employing people with particular skills (such as unnecessarily restrictive visa requirements or local content requirements) will inhibit business set-up. New businesses can face particular difficulties in attracting and retaining highly skilled employees, particularly those with skills sought after internationally in multiple sectors. Conversely,



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arrangements around employee disengagement and entitlements may impact on the ease of closing businesses.

A sufficient proportion of the workforce with the core skills needed by new businesses is a necessary condition for the development of ideas into new businesses. There are different views on what these core skills are — science, technology, engineering and maths (STEM) subjects have been highlighted by some as critical (Deloitte Access Economics 2014), as has training in adaptivity, creative thinking and change implementation (as necessary skills for entrepreneurship) (see chapter 10 and appendix E for more discussion on these). Employees of start-ups, for example, might be expected to have the capacity/skills to figure out what their job should be every day, how to accomplish things that have never been done before and when to throw out everything that’s already been done and start over (Global startup ecosystem ranking 2015). Lack of skills in strategic management of a business, lack of record keeping and management of accounts have also been cited by administrators as common reasons for business failure (figure 2.14).

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**Figure 2.14 Why companies fail**

Reasons identified by practitioners, 1 July 2006 to 21 April 2015



Source: ASIC administrative data



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## 3 Setting up a business

### Key Points

- The generic registrations needed to set up a business in Australia are relatively straight forward and speedy. The Commission has no major concerns about their operation.
- There is a range of legal structures that can be used to set up new businesses. The four main structures are sole traders, partnerships, companies and trusts. The choice of legal structure is determined by the interplay of a host of factors such as asset protection, liability, succession, profit or loss distribution, and tax management.
  - The taxation of businesses, and the distortions created by the tax regimes that differ by legal structure, should be examined in the White Paper on the Reform of Australia's Tax System.
- 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.
- Restrictions on new business entry come in many guises and there is an urgent need for governments to revisit restrictions that are deliberately or inadvertently anti-competitive.
- Ongoing compliance issues are a major concern for business, particularly in the areas of taxation and employment. 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 issues around 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; be determined by the legal structure the business is set up under; or be specific to the nature of the proposed business activity — some industries have significant regulatory requirements for entry.

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. These differences create incentives to choose particular structures over others and can create distortions in the economy.

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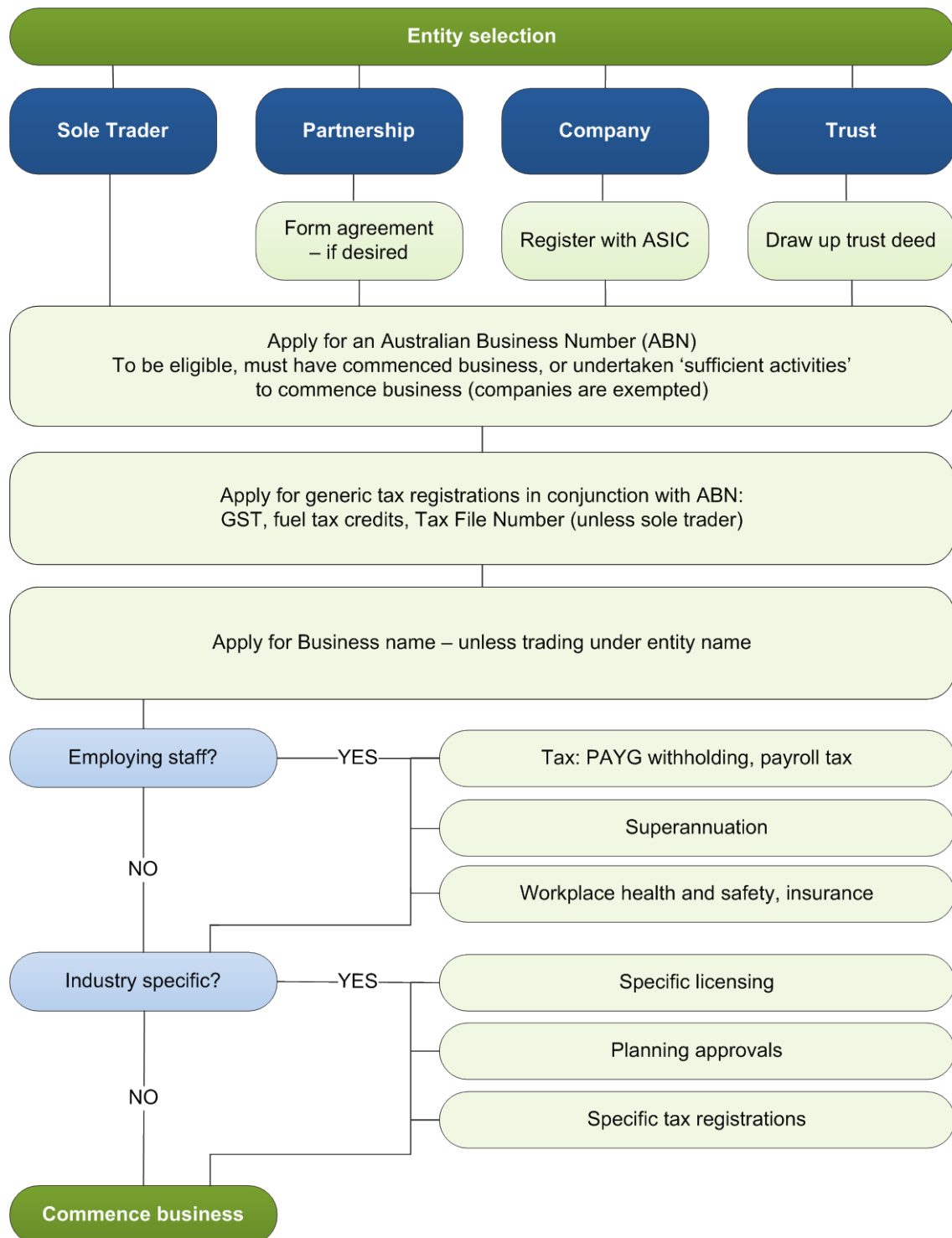
Regulatory requirements can create a disincentive to business establishment if they create costs that are unnecessarily high to achieve regulatory objectives, and/or are overly complex, and discourage would-be business people. Some regulatory restrictions on the entry of new businesses in some industries 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 in order 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 a business, such as setting up bank accounts and websites, and obtaining professional advice and insurance. The processes for undertaking these requirements are more fully explained in appendix C.

As indicated in figure 3.1, entity selection is a key initial step in setting up a business. There are four main entity types that are used in Australia to set up and run businesses — sole trader, partnership, company and trust. The key features of each structure are illustrated in table 3.1 and explained in more detail in appendix C.

Figure 3.1 Regulatory steps for setting up a business



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**Table 3.1 Summary of key features of different entity types**

<i>Entity type</i>	<i>Key Features</i>
Sole Trader	<ul style="list-style-type: none"><li>• Simplest business structure, indistinct from owner</li><li>• Business income or losses included with other income in individual's tax return and taxed at personal tax rates</li><li>• Individual is personally liable for business debts</li></ul>
Partnership	<ul style="list-style-type: none"><li>• Similar to sole trader, but with two or more people (or other entities) as co-owners</li><li>• Share of business income or losses from partnership included in each partner's individual tax return and taxed at their personal tax rates</li><li>• Partners are joint and severally liable for business debts</li></ul>
Company	<ul style="list-style-type: none"><li>• Distinct legal entity</li><li>• Company profits are taxed at the flat corporate tax rate</li><li>• Profits can be passed through to shareholders as dividends (where they are taxed at marginal personal tax rate, less franking credits)</li><li>• Losses cannot be distributed to shareholders, but are retained and offset against future profits</li><li>• Shareholders' liabilities are limited, although there are duties imposed on directors</li></ul>
Trust	<ul style="list-style-type: none"><li>• Obligation imposed on a trustee to hold assets for the benefit of others (the beneficiaries) — established by a trust deed</li><li>• Earnings are passed through to beneficiaries, added to their individual tax returns and taxed at their personal income tax rates</li><li>• Losses are not passed through to beneficiaries</li><li>• Earnings retained in the trust are taxed at the top marginal tax rate</li><li>• In a discretionary trust, the trustee can choose how earnings are distributed between beneficiaries</li></ul>

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Of the 2.1 million businesses in Australia reported by the ABS (Cat. No. 8165.0)<sup>8</sup>, 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). Over the last five years, there has generally been an upward trend in the numbers of companies and trusts<sup>9</sup>, but a downward trend in the numbers of sole traders and partnerships (figure 3.2). Further data on business numbers by type of legal entity are in appendix B.

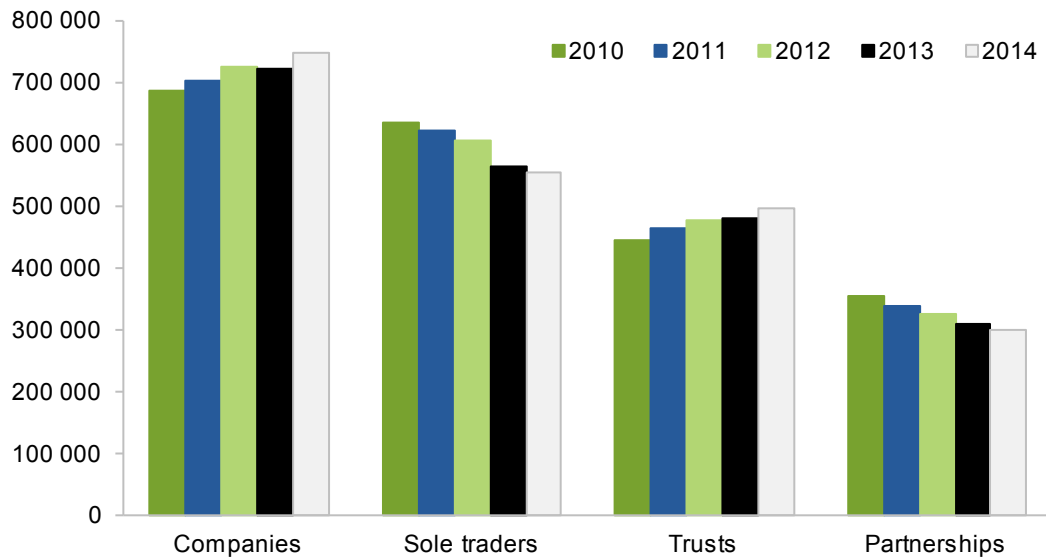
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<sup>8</sup> This count excludes around 54 000 not-for-profit businesses and micro businesses (including around 460 000 sole traders) that are not registered for GST (see chapter 2).

<sup>9</sup> Businesses counted as trusts include many operated as self-managed superannuation funds (see appendix B).

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Figure 3.2 **Australian private sector businesses, by entity type**  
Number operating at 30 June



Source: ABS (2015d)

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### Are the generic set-up requirements too onerous?

The Commission has received no evidence that the generic requirements to set up a business in Australia represent a serious impediment to setting up a new business. In part, this is a reflection of recent reforms to streamline requirements, such as the nationalisation of business name registrations and improved information provision to prospective business owners, such as through the *business.gov.au* website.

However, there remain 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)

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ACCI also noted the array of requirements on new businesses and 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 (CCIQ) 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 study into *Regulator Engagement with Small Business* (PC 2013c). That study found that there is scope for significant 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:



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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 [Australian Financial Services] licence application process [for businesses in the finance sector];
- (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, there were concerns following the establishment of the national system relating to transitional and transfer issues. For new businesses, registering a business name is generally a speedy, online process. As 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)

However, changes to business name registrations were recently announced, which are aimed at limiting new business names from being registered that are nearly identical to existing registered names (Billson 2015).

The Australian Business Register, in its administration of the ABN application process, has also developed its processes over time. The addition of a questionnaire to determine ABN eligibility at the beginning of the ABN application process, as well as procedures to reduce clerical errors has increased the proportion of applications that are completed immediately. In practice, the eligibility thresholds for an ABN are low and easily met and obtaining an ABN does not present a serious impediment to setting up a new business.

## **What motivates the choice of business structure?**

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

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## 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, investors of 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 providing returns on capital, such as improving the owner's labour earnings, or as a means of providing employment for associates or family, in which case a sole trading or trust arrangement might be most appropriate. 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. For example, for a small number of active business participants a partnership may be used, but a company structure may be more appropriate if ownership is to be spread amongst a broader group or there is the intention to access equity finance, although partnerships are easier to exit if a principal's circumstances change.

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 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 legal entity.

## 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, and need for specialist professional advice, of more sophisticated structures, particularly trusts, may inhibit some businesses being set up using these structures, notwithstanding the potential benefits of doing so.

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## Tax

As noted above, there are fundamental differences in the taxation treatment of businesses operating under the different entity types. 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 included: 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

Legal 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 and other liabilities incurred by the business. In a partnership, partners are personally liable for liabilities 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

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engage in insolvent trading. If the company does trade while insolvent, directors are liable to a range of civil penalties, compensation proceedings and criminal charges. Directors and shareholders may also increase their liability through the use of director and shareholder guarantees. These are commonly used by small companies to access finance, whereby personal property, such as a home, is used 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 3.3 provides an illustrative

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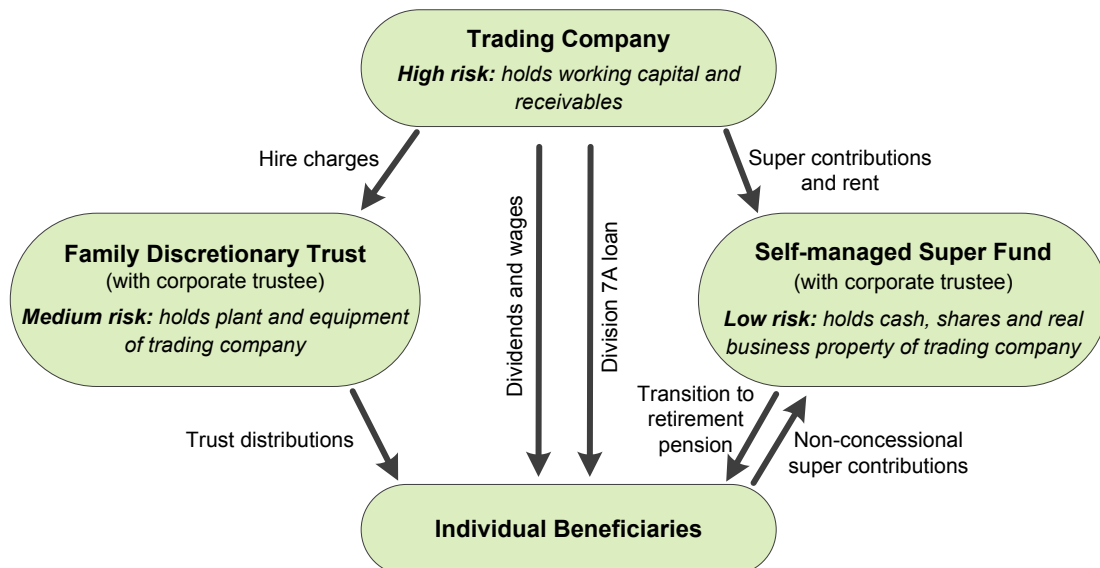
example of the use of multiple structures to run a business (this example also includes the additional use of a self-managed super fund).

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. Such structures can facilitate the future transfer of individual business activities and can enhance corporate governance by allowing expert directors focused on the affairs of the subsidiary rather than the group as a whole.

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

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Figure 3.3 **Stylised example of a complex business structure**



Source: Adapted from The Board of Taxation (2014)

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### Issues and concerns with available business structures

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

- the 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.

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## Issues around the regulation of companies

Relatively few concerns regarding the regulation of companies were raised during this inquiry. Concerns were raised that it can be 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. This is discussed further in chapters 14 and 15.

Some issues surrounding the use of company structures 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 to business establishment, in so far as they make the choice of a company less attractive for starting a business than it might otherwise be.

Other issues 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.<sup>10</sup> 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. The structure is not even widely used in mining. 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).

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<sup>10</sup> In no liability companies, the company cannot demand that shareholders pay unpaid amounts on part paid shares (see appendix C).

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### *Utilisation of losses*

The tax system treats losses differently to profits. While profits 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 the one hand, and companies and trusts on the other, can affect the choice of structure. For instance, if there is a likelihood of an initial loss from the business venture then the former structures may be chosen so as to apply those losses against other income.

However, the restrictions around the use of losses can also affect expansion and investment in new activities by existing businesses. If the new investment presents the possibility of causing a loss, the 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 paid on profits from previous years.

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 2015c) 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, other than in relation to farms, 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

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particular, the retention of profits for business expansion purposes). Trusts are inherently complex and opaque structures used to protect assets and potentially minimise tax. 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 2013c).

There have also been a series of review processes that identified the need for reform around the taxation of trusts. For example, 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) and then released an options paper on reform options (The Treasury 2012). The latter 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, about the operation of businesses through trusts (box 3.1).

Perhaps the most significant concern is the operation of Division 7A of Part III of the *Income Tax Assessment Act 1936* (Cth), 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 3.2).



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**Box 3.1      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. This was deferred to the Board of Taxation inquiry (box 3.2).
- 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 the succession process. There were changes that made trust cloning (creating a new trust with the same terms and beneficiaries) 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 assets being tied up 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)

Another 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.

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### Box 3.2      **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 of Taxation'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.

The Commission has heard that the use of trusts is often not well understood by business owners adopting them. The Commission was also told that in many cases, they are an

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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 members of partnerships 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 corporation' 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)

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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 (primarily to reduce barriers to 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, were noted in the initial discussion paper released in March 2015 as part of the White Paper process. In particular, the paper noted 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 2015c, pp. 105, 108)

The discussion paper also made particular reference to the possible introduction of an S corporation, noting potential benefits such as 'reduced establishment cost and complexity, limited liability (which follows from a corporate structure), and tax treatment similar to a partnership, including for losses' (The Treasury 2015c, p. 109). However, the discussion paper also noted that in some respects they are not as advantageous as trusts; can have complex reporting and administrative requirements; and are useful in the US context to avoid double taxation of corporate profits, which is not relevant in Australia where dividend imputation is available. The discussion paper concluded that:

While, in isolation, an S-Corporation style entity may be an attractive option for some small businesses, introducing such an entity in Australia without otherwise reducing the complexity of the tax system may have mixed impacts on the overall compliance burden for small businesses. This is because businesses will need additional time and possibly professional advice to determine whether such an entity would be better overall than the existing suite of complex structures. (The Treasury 2015c, p. 110)

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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. If a new corporate structure — such as along the lines of an S Corporation — is recommended by the White Paper, then some broader insolvency matters will need to be considered alongside the taxation issues before implementation. Of note, these include specifying how flow-through transactions to shareholders are treated with respect to avoidable transactions and directors’ duties regarding insolvent trading.

RECOMMENDATION 3.1

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 across business types
- the feasibility of a simpler entity for small business that would combine features of existing structures.

## 3.2 Requirements applying to specific business activities

In addition to generic regulatory requirements that apply to most businesses, there are specific requirements that exist for businesses engaged in particular activities and industries. Specific regulatory requirements are more likely to impede business set-up than the generic requirements discussed above. These include: licences, registrations or approvals to operate; acquiring relevant re-zoning and development consent; reporting system requirements; and staff qualifications. The nature and extent of these requirements vary across industries and jurisdictions and often involve dealing with multiple regulators from the Australian, state and territory and local governments.

Many of these processes generate significant net social benefits, but some can impose excessive and unnecessary regulatory burdens and impede new businesses. Generally, these impediments can be classified as either location specific (such as planning and zoning), or requirements specific to the business activity (such as 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. These have been

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raised as an issue by a number of participants to this inquiry. For example, the Australian Property Institute submitted that:

... 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 said:

... 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 and 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 impost on business, including 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 (box 3.3).

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)

The Property Council of Australia has also recently noted the variation that still exists in development assessment procedures across jurisdictions (box 3.4).

To date, planning and zoning reform has been limited and patchy, in part due to the very large number of jurisdictions (560 plus local government authorities plus state planning agencies) with regulatory responsibility. Nonetheless, state, territory 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.

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### Box 3.3 **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 than 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 imposing 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)

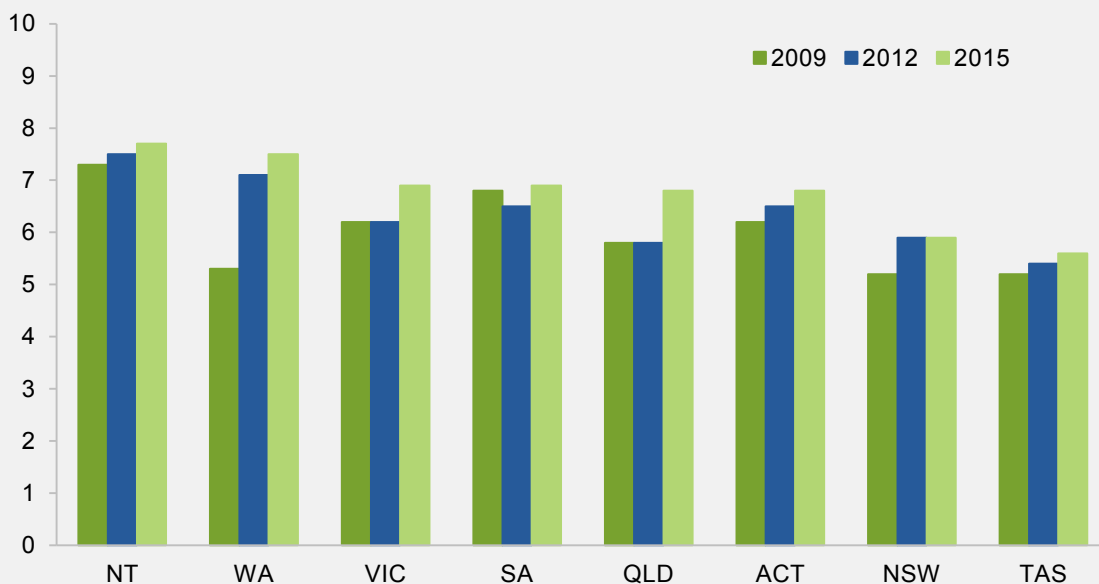
### Box 3.4 Development assessment scope for improvement

The Property Council of Australia has undertaken an analysis of the development assessment processes in each state and territory. Each jurisdiction is scored (out of ten) against each of 10 leading practice principles, with the scores combined (as a simple average) to give an overall score.

The assessments highlight that there is variation in the perceived merits of the development assessment processes across jurisdictions. However, it also shows that in general there have been improvements over time.

While the scoring system has its limitations — it is unlikely that each principle against which jurisdictions are assessed is equally important — it nonetheless illustrates that, particularly in Tasmania and New South Wales, there remain areas for improvement.

#### Report card scores (out of ten) for each jurisdiction



Source: Property Council of Australia (2015)

## Business-specific approval requirements

Business or industry specific approvals, licences and accreditations can be a significant area of 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 licences 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.



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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 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, registration and compliance 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.

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#### RECOMMENDATION 3.2

Governments, particularly those at a state, territory and 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 Regulator* (2012)
- *Regulator Engagement with Small Business* (2013)

#### Government restrictions on entry can be anti-competitive

Governments can also impose various restrictions on new entrants that can directly affect the set-up of particular types of businesses. 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.

Restrictions on new entry may seek to address market failures such as a lack of information on service quality. 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 the restrictions:

... 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

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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. There is an urgent need for governments to revisit entry restrictions to assess whether they generate a net benefit to the wider community, or they are the best way of achieving government objectives. This is particularly necessary in markets facing 'disruption' brought on by new business models (chapter 8).

**RECOMMENDATION 3.3**

Industry-specific regulations that restrict business entry and the competitive operation of markets should be reviewed or removed, as recommended in the Harper Review. In reviewing their regulations, governments should assess whether they generate a net benefit to the community and whether they are the best way of achieving government objectives.

### **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)

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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 is 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.

- Taxation, both the compliance burdens and the rates of taxation, is a major issue influencing decisions related to business set-up. Tax impediments facing small businesses were recently reviewed by the Board of Taxation (2014). Business taxation will also be covered in the White Paper on the Reform of Australia’s Tax system. The initial discussion paper (The Treasury 2015c) raised issues around 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 compliance obligations, and costs, associated with employing staff under Australia’s workplace relations system may also act as a barrier to business set-up or expansion. The Commission is reviewing the impacts of Australia’s workplace relations system on businesses (among others) in a concurrent inquiry, with a draft report released in August 2015 and a final report due to Government in November 2015.

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## Minimising the overall regulatory burden on business

While regulatory requirements often have legitimate public policy objectives, particular regulations may be redundant, ineffective, excessively complex or costly.

This fact is recognised by 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 2013c), 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.



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## 4 Restrictions on business

### Key points

- There is a vast array of regulations and industry practices that can impact, intentionally or not, on decisions to start, close or transfer businesses.
- 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 restrictive 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.
- Land tenure arrangements can create barriers to new business set-up, transfer and closure. Governments should increase momentum on land reforms — especially those directed 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, the regime does not appear to create a significant barrier to foreign investment in new or existing businesses.
- Other potential barriers to business set-up, transfer and closure include issues around government procurement; 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 many other regulatory and industry arrangement that could potentially influence business set-up, transfer and closure. Many of these restrictions are not specific barriers to setting up a new business per se, but rather create market distortions that influence business activity and affect the incentives to start new businesses or create pressures to close or transfer existing businesses.

This chapter examines a range of these potential restrictions on business, including: business to business contract arrangements; land tenure arrangements; foreign investment restrictions; government procurement processes; restrictions on public asset purchasers; competitive neutrality; import barriers; and other industry arrangements.

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## 4.1 Business-to-business contracts

Newly established businesses are likely to enter into a number of contracts with other businesses to supply or obtain a range of goods and services. Aspects of business contracts that can impede business set-up, transfer and closure include unfair terms and conditions in standard form contracts, terms and conditions in leases, restrictive franchising arrangements and switching costs. A common theme underlying each of these barriers is an imbalance of power between the parties in negotiating contracts.

### Standard form contracts

Many business-to-business contracts are standard form contracts that do not vary substantially between contracting parties. Such contracts are commonly used, for example, for telephone, internet and electricity services, commercial leasing and debt financing.

In these transactions, new small businesses share many similarities with individual consumers:

- Contracts can be lengthy, complex and incorporate legal terminology. Business owners may not have the expertise to fully understand all elements of the contract nor the capacity to engage legal or professional advice.
- Given their small size, the new business's bargaining power is typically relatively low, especially if the other party is one of only a few suppliers of the product or service and the contract is offered on a 'take it or leave it basis'.

There are currently two forms of protection against unfair terms and conditions in standard form contracts.

The first form is 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, which was found to have engaged in unconscionable conduct in its dealing with more than 200 of its suppliers in 2011. The Harper Review considered that the Federal Court case indicated that the current unconscionable conduct provisions appeared to be working as intended, but concluded that active and ongoing review of these provisions should occur (Harper et al. 2015).

The second is 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 that caused consumer detriment in consumer to business contracts (PC 2008b).

The Australian Government has committed to extending these protections to small businesses. The Treasury Legislation Amendment (Small Business and Unfair Contract



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Terms) Bill 2015 was introduced to Parliament in June. The protections will apply where either, or both, of the parties is a small business (defined as having fewer than 20 employees) and the value of the contract does not exceed \$100 000, or \$250 000 for contracts of more than one year in duration. The stated purpose of these restrictions is to limit protections to small businesses that may lack negotiating power, and for lower value ‘day-to-day’ transactions, but exclude transactions where it would be reasonable to expect businesses to undertake due diligence, such as seeking legal advice, before entering contracts (Treasury Legislation Amendment (Small Business and Unfair Contract Terms) Bill 2015, Explanatory Memorandum).

In submissions to this inquiry, the Shopping Centre Council of Australia has raised concerns about the extension of unfair contract provisions to small businesses and submitted that there has been insufficient analysis to justify such an extension (sub. DR45). They did not, however, provide such an analysis in support of their concerns nor did they provide information upon which such an analysis could be based.

In the absence of solid evidence of the problems asserted by the Shopping Centre Council of Australia, the Commission continues to support 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.

However, crucial issues in implementing an extension to small businesses include identifying those small businesses in scope and, more particularly, what contracts should be covered. On the one hand, while it might be expected that small businesses should undertake due diligence for higher valued contracts, it is likely that this will often not occur. This may particularly be the case for longer-term contracts, such as leases, where there may be less cognisance of the total value of the contract. On the other hand, consideration should be given to the possibility for the provisions to alter the behaviour of small businesses if the consequences of poor business decisions can be shifted through small businesses avoiding their contractual obligations.

It seems to the Commission that this will be best judged with experience. The Commission supports a review of these reforms within five years and urges the Treasury, as the policy department responsible, to ensure that when the reforms take effect, adequate data collection arrangements are in place to facilitate such a review.

#### RECOMMENDATION 4.1

The extension of protections against unfair contract terms to small businesses should be reviewed within five years. The review should include examining if the provisions are being misused by businesses to avoid contractual obligations. To facilitate such a review, the Treasury should ensure that adequate data collection arrangements are in place.

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## Commercial leasing arrangements

A common step setting up a businesses is to enter into commercial leasing arrangements covering property, vehicles, plant or machinery. Several issues have been raised about retail leases, in particular, 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 2015b).

One issue is that tenants usually 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 may not be given the opportunity to renew their new contract before negotiations begin with other interested parties. This could result in a viable tenant being forced to exit — not because they are unsuccessful, but because of a change in the landlord’s desired overall mix of tenants at the retail site. 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 new businesses setting up, as landlords would have a reduced ability to negotiate with new potential tenants. In general, the Commission is not in favour of unduly restricting the commercial arrangements between landlords and their tenants where lease renewal options (or the lack of) are clear to both parties from the start.

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 tenants to continue operating to recover refit costs. However, such requirements will be specified in a lease agreement and can form part of initial contract negotiations, diminishing the case for any government intervention.

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 increase 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 4.1). 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.

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**Box 4.1 Recent state and territory government progress on retail tenancy reform**

- The New South Wales Government established the Office of the NSW Small Business Commissioner in mid-2011, which 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); Senate Economic References Committee (2015b); Small Business Commissioner (SA) (2014)

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## Franchise arrangements

Many people start a business for the first time through a franchise arrangement, whereby a franchisor assigns the franchisee the right to market or distribute their goods or services, and to use the business name for a period of time (FCA 2013). In 2014, there were an estimated 1160 franchise formats in Australia with 79 000 franchise units operating (Frazer, Weaven and Grace 2014). Franchise arrangements are subject to a mandatory Code of Conduct that is monitored and enforced by the Australian Competition and Consumer Commission (ACCC) (box 4.2).

Recent concerns about franchising arrangements and the Code, identified by the Wein Review of the Franchising Code of Practice (2013), submissions to this inquiry (sub. DR70) and others, have included:

- asymmetry between franchisors and franchisees, including 'onerous' contract requirements offered by franchisors on a 'take it or leave it' basis
- a lack of transparency and disclosure by franchisors, for example, in relation to marketing funds, online sales and the growth in the number of new franchises, which makes it difficult for prospective franchisees to undertake due diligence
- 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

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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 (or transfer of ownership) on franchisees and, in particular, how they sit with respect to creditors and employees in recovering outstanding debts and entitlements from the franchisor.

#### **Box 4.2      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.

Following the Wein Review, a new Code was introduced 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.

### **Switching costs**

Businesses starting out that are cash constrained may opt for the cheapest upfront contracts even though they include 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).

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Switching costs do not necessarily impose unreasonable barriers on 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. However, 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, although subsequent reforms (which included a ban on exit fees for home mortgages) did not address this (Australian Government 2012a). While a working party was established to consider extending the scheme to small businesses, its work has not progressed. Also, data analysed 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.<sup>11</sup> While switching costs may occur in contracts, there are beneficial trade-offs for businesses. Even if there were a role for government, evidence of the operation of the banking switching scheme for ordinary transaction accounts suggest that such intervention could have limited additional benefits.

## 4.2 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.

The most common types are Crown leasehold (mainly pastoral) and freehold. Together these types of land tenure account for 60 per cent of Australia, with most of this being Crown leasehold (Geoscience Australia 1993). Other types of land tenure include: Aboriginal freehold, leasehold or reserves (accounting for 14 per cent of Australia);<sup>12</sup>

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<sup>11</sup> 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.

<sup>12</sup> 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).

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vacant and other Crown land (11 per cent); nature conservation reserves (8 per cent); defence land, forestry reserves, water reserves and mixed category land (4 per cent); and marine reserves.

Land tenure arrangements address a range of objectives, including: environmental and biodiversity conservation; providing certainty in property rights; controlling the use of land for particular purposes; controlling access to common property resources attached to land such as oil, minerals and fish; 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 2013; Forrest 2014) have drawn attention to the restrictiveness of land tenure arrangements. For example, the White Paper on Developing Northern Australia (Australian Government 2015h) 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)
- 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 impose barriers to business set-up, transfer or 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 — particularly in regard to alternative activities on pastoral leasehold land — are underway in a number of jurisdictions to simplify processes, encourage more flexible and innovative land use and increase certainty for business. The White Paper on Developing Northern Australia has

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also flagged a number of initiatives to reform land tenure, including the use of native title rights for commercial purposes (Australian Government 2015h).

The Commission urges governments to maintain momentum in land reforms, particularly given a significant proportion of land is held as Crown leasehold.

RECOMMENDATION 4.2

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

### 4.3 Foreign investment restrictions

Foreign investment can be a 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, or the full or partial acquisition of existing Australian businesses. It also can facilitate technological and managerial expertise transfer.

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 4.3 sets out the types of proposals that require approval).<sup>13</sup> After conducting a review, FIRB advises the Treasurer on whether or not to allow a proposed investment and if so, what, if any, conditions should 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).

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. Business-related foreign investment accounted for only 4 per cent of FIRB approvals in terms of numbers, but 79 per cent of approvals by value (FIRB 2015). Data on foreign investment into Australia is detailed in appendix D.

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<sup>13</sup> 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 2015a).

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Although the objective of FIRB reviews is to ensure proposals are not contrary to the national interest, there are several aspects of the process that could potentially be barriers to foreign investment and to business set-up, transfer and closure.

**Box 4.3      Restrictions relating to business set-up, transfer and closure under the Foreign Acquisitions and Takeovers Act**

- Foreign government investors must notify the Australian 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.<sup>14</sup>
- 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 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 (2015e); Hockey (2015a)

Monetary thresholds are used 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

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<sup>14</sup> 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,



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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 2015), the thresholds do not appear to be significant barriers.

That said, a higher threshold of \$1094 million applies with respect to some foreign investors through relevant free trade agreements (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 obtain 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 may do so for political rather than commercial reasons.

However, the Law Council of Australia has suggested that the additional scrutiny faced by foreign government investors is more onerous when compared with that in 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 to consistently identify the different classes of foreign government investors.

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 thresholds may be altered through free trade agreements. It has been suggested that Australia could benefit from a clearer and more uniform policy towards foreign investment, rather than allowing increased FIRB thresholds to be negotiated in free trade agreements (Lowy Institute 2015). The Commission has been presented with no evidence of any confusion around FIRB's approach to commercial investment proposals, but considers that the Government's planned simplification of Australia's foreign investment framework should ideally increase transparency around thresholds.

Fees for foreign investment applications are to be introduced from 1 December 2015 (Australian Government 2015e). 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 no evidence has been received on the potential impact of the fees on foreign investment proposals.

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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.

## **4.4 Other potential barriers**

Other government and industry restrictions that could potentially be barriers to business set-up, transfer and closure include:

- government procurement practices
- restrictions on the purchasers of public assets
- competitive neutrality
- import restrictions
- industry codes of practice or requirements.

### **Government procurement practices**

Various participants to this inquiry and other studies 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; PC 2014d; PwC 2013; Senate Finance and Public Administration References Committee 2014). Identified 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.

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 (Minister for Finance and Minister for Small Business 2014).

However, there have been suggestions for further reforms to government procurement practices. For example, introducing electronic procurement systems that enable pre-registration or pre-authentication of tenderers (PwC 2013).

Recently, the Harper Review on competition policy recommended that all governments should review their procurement practices (and all their commercial arrangements with the private sector and non-government organisations) and that competition principles be

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incorporated into procurement practices (Harper et al. 2015, rec 18). The Commission endorses the Harper Review’s suggestions on government procurement practices.

## **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 conditions for the partial long-term lease of its electricity networks, including around pricing, reliability and the protection of employees’ jobs (NSW Government 2014c, 2014d).

The Commission considers that governments should seek to maximise community-wide net benefits when public assets are privatised. While conditions are intended to address community concerns, they can impose 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 2013a 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 range of markets. A lack of neutrality in how they compete can deter the entry of privately owned businesses or hasten their exit.

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. The majority of competitive neutrality concerns arise with respect to state and local governments.

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).

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Similar concerns about implementation, particularly by small business, were also raised with the Harper Review of competition policy. It recommended that 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 reporting (Harper et al. 2015, recs. 15 to 17). The Commission endorses the Harper Review’s recommendations on competitive neutrality.

## **Import restrictions**

New businesses may seek to import goods or services as lower cost inputs to their activities, or for distribution in the domestic market. Some new businesses are established because they have exclusive distribution rights for a new imported product, although there are no restrictions around this practice and no particular issues were raised.

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. These barriers can reduce economic efficiency, add to regulatory burdens, and create barriers to business set-up, transfer and 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.

## **Voluntary industry codes of practice and requirements**

In starting out, a business may need to comply with industry self-regulation (such as industry codes of practice) or other requirements in order to access existing markets.

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.<sup>15</sup> Requirements under the voluntary industry codes do not appear to be significant barriers to business set-up, transfer and closure.

Other, non-regulatory, industry requirements have the potential to prevent, or significantly add to the costs of, non-participants setting up a business. An example is the Cabcharge payment system, originally established by the taxi industry to facilitate non-cash payments (chapter 9).

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<sup>15</sup> 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.

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## 5 Access to finance for new businesses

### Key points

- There is an array of potential finance sources available to new businesses including: the personal finances of business owners, venture capital, bank loans, government grants, peer-to-peer lending, private and publicly-raised equity and crowd-sourced equity finance. The ability to access different types of finance depends on the nature of the business and the stage it is at.
  - 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.
  - Many new businesses do not require financing that is external to the resources of business owners.
- The financing mix of new businesses is determined by several factors including the cost, availability and complexity of different finance types and the amount of finance needed.
- New businesses can face considerable financial uncertainties, including around future costs and revenue streams, the market appetite for new products and services, the regulatory environment and/or the viability of unproven business models. Lack of information about these risks, volatile revenue flows that make it hard to service a loan and a deficiency of assets to use as loan collateral can make it more difficult to secure adequate financing at an acceptable cost for some new businesses.
- A number 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, entrepreneurs and business associations.
- Innovative new businesses are more likely to identify access to finance as a barrier. This can particularly be the case when an unproven business model creates additional uncertainty for lenders and investors. 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.

Setting up a new business entails costs. For some new businesses — such as a consultancy business with a single professional employee — these costs are minimal. For others, inventory, inputs or plant need to be bought, premises leased and staff employed. External finance — that is, finance beyond the personal resources of the business owner — may be sought to meet such costs.

It is inevitable that for some new businesses, accessing finance is difficult. By their nature, most new businesses are unproven — and some proposals are unviable or unsustainable. Some new businesses without a fully developed and credible business plan, may — unsurprisingly — find it difficult to access external finance.

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In examining the ability of new businesses to access finance, the Commission has sought evidence of widespread or systemic difficulties or issues, including for particular types of new businesses, or for particular types of financing.

The extent to which 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 discuss 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 [Global Financial Crisis] 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 accessing 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:

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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.

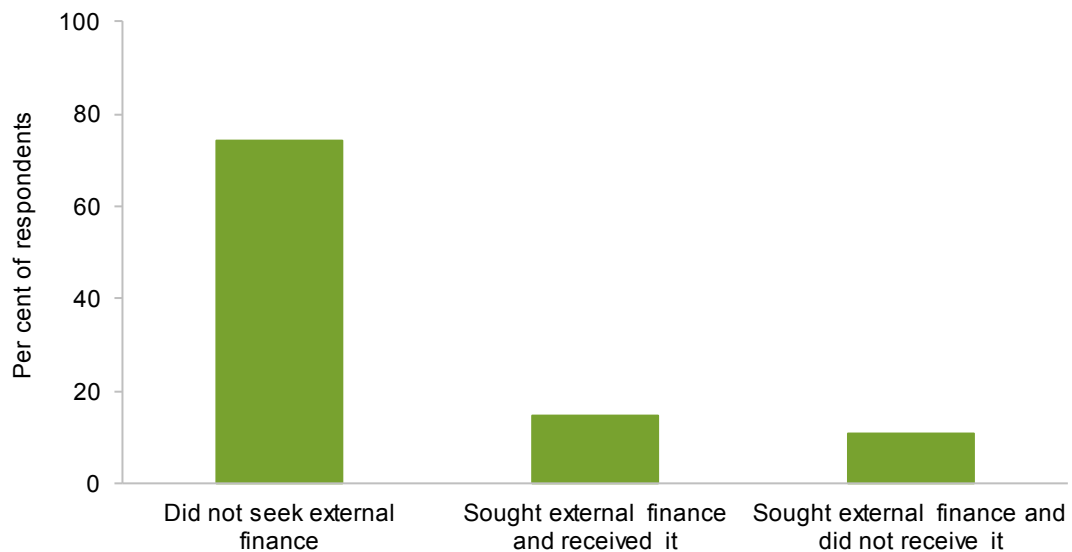
... Small businesses and start-ups have specific needs, requirements, issues and risk profiles compared to larger businesses. (p. 8)

### ... but broader evidence suggests problems are not widespread

Several recent studies highlight that most new businesses in Australia do not seek external finance. For example, Davidsson, Gordon and Steffens (2012) found that around three-quarters of nascent businesses do not seek financing for the business itself (figure 5.1).<sup>16</sup> 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.

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Figure 5.1 **Nascent businesses seeking external finance<sup>a</sup>**  
2007–2011



<sup>a</sup> Includes both equity and debt finance

Source: Davidsson, Gordon and Steffens (2012)

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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. Commission discussions with a range of

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<sup>16</sup> Davidsson, Gordon and Steffens (2012) define nascent businesses as ‘firms in the processes of being created, but not yet established in the market’.

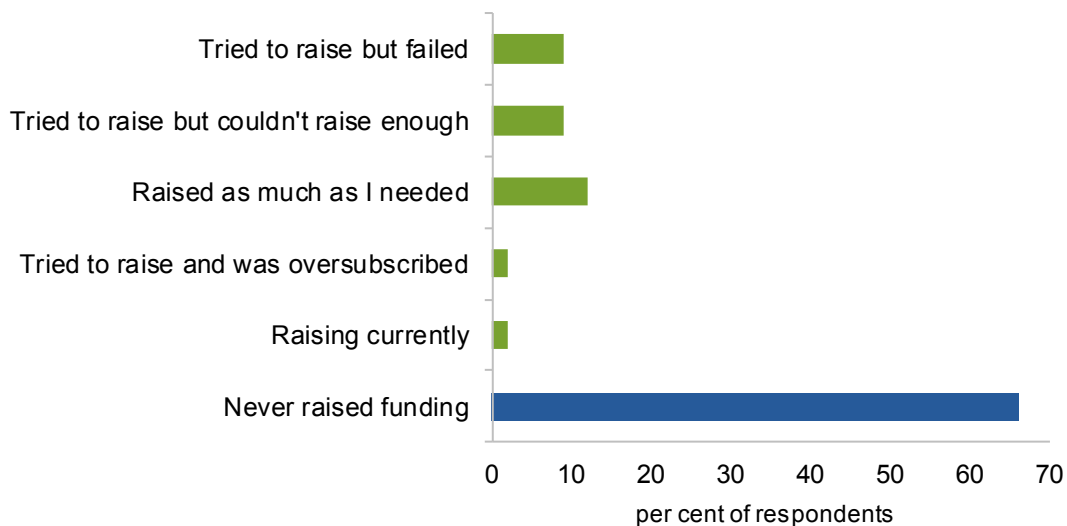
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participants during the course of this inquiry suggest that in many of the cases where finance could not be obtained, the organisation lacked a viable business case or was unable to demonstrate it to a reasonable level of detail.

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) did not try 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).

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



Source: Startup Muster (2015)

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Studies that examine the ability of all (not just new) small and medium businesses to access finance are more common. Given that the vast majority of new businesses begin as small businesses, these studies can also provide broad but useful indications about how difficult accessing finance may be for new businesses.

- A report by Deloitte Access Economics (2013a) 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.
- Holmes and Gupta (2015) found that access to finance was not a high priority issue for small Australian businesses, with concerns of higher importance including maintaining and growing revenue, economic uncertainty, competition and red tape, taxation and compliance. However, difficulty accessing finance was more pronounced for some businesses than others. For example, for businesses categorised as ‘financially



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constrained growth aspirers', access to finance was reported to be much more of a concern than for the wider small business population.<sup>17</sup>

- Research undertaken by the Australian Bankers' Association and the Council of Small Business Australia estimated that around 11 per cent of small businesses stated that 'access to finance or the capacity to finance further growth in the business is an issue' (ABA and COSBOA 2013, p. 7). However, 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.
- CPA Australia (sub. 30) quoted results from their 2014 small business survey that found that half of respondents considered 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, 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 small and medium enterprises (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 2014, pp. 2-60). The report 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' (pp. 2-59). The Commission's investigations indicate venture capital is typically only available to some start-ups, and then not in the early nascent stage (chapter 6).

These studies broadly suggest more favourable investment conditions for SMEs than studies undertaken in the immediate aftermath of the Global Financial Crisis (box 5.1). These studies also suggest that the situation of businesses not applying for finance because they consider there to be little chance of having their application approved is not widespread.

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<sup>17</sup> The study notes that 'financially constrained growth aspirers' are 'younger businesses mostly seeking growth but are struggling to achieve it' (p. 46). Most businesses who fall into this category are small (90 per cent have less than four employees with below average revenues) and relatively young (44 per cent have been in operation for less than three years).

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### 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 US National Bureau of Economic Research 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 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).

By drawing on these studies, the statistical evidence and the information presented to the Commission during consultations, the Commission's draft report concluded that, for most businesses, access to finance does not represent an impediment or barrier to setting up. This conclusion was challenged by several post-draft submissions to this inquiry.

For example, the Chamber of Commerce and Industry Queensland presented:

Access to finance is a significant issue for all small businesses looking to invest and grow, and is particularly difficult for entrepreneurs looking to fund a new idea. (sub. DR44, p. 2)

In response, the Commission has examined access to finance for particular types of businesses and business owners.

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## **Do particular types of business owners have difficulty accessing finance?**

Some submissions presented that particular business owners experience relatively more difficulty accessing finance than the general business owner population. For example, economic Security4Women submitted:

Access to finance is a HUGE issue for women who go into business. We would suggest to you that many small businesses are boot strapped because getting finance is TOO HARD. (sub. DR39, p. 1, capitalisation in original)

The extent that women find it more difficult to access finance has been examined considerably by international research, with mixed results. In one of the few Australian studies, van Hulten (2012) found that gender did not appear to influence the rates at which entrepreneurs were denied (or discouraged for applying for) finance.

The Foundation for Young Australians (sub. DR56) indicated that roughly three-quarters of entrepreneurs engaged in their Young Social Pioneers accelerator program identified that they had difficulty accessing finance. Apart from the general patronising response that young people often experience when seeking professional services, the Foundation notes that younger entrepreneurs typically have little or no assets to secure a loan and an unproven credit record.

Indigenous Australians are also often identified as having additional challenges when seeking finance for a business. Indigenous Australians living in regional and remote communities often lack access to financial institutions, and many do not have sufficient collateral to obtain a loan (land held under Native Title cannot be used as collateral Furneaux and Brown 2008). Foley (2006) also identified challenges for Indigenous business owners in urban areas.

The Australian Government provides assistance to Indigenous business owners through the Business Development and Assistance Program. Under this program, businesses operated by Indigenous Australians may be entitled to concessional loans or other forms of government support. Further information on this program can be found in appendix E.

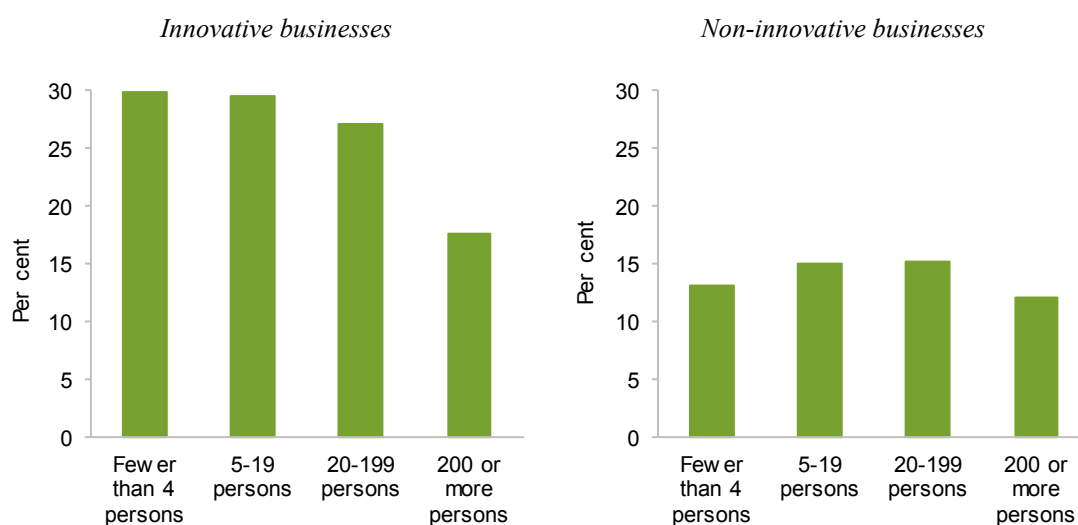
## **Do innovative businesses have difficulty accessing finance?**

It is not unexpected that innovative new businesses may encounter additional difficulty accessing finance compared to new businesses that largely replicate existing and proven business models. Innovative business models are often knowledge or technology based (rather than hold tangible assets) or operate in regulatory ‘grey areas’. Further, the performance of innovative businesses is highly variable — while some become highly successful, many others fail. As a consequence, financiers may have difficulty judging the rewards and uncertainties from investing in an innovate business, and therefore may be hesitant to provide finance.

This is reflected in ABS data that indicate smaller, innovative businesses are more likely to report that access to additional funds is a barrier to innovation than both larger, innovative businesses and non-innovative businesses (figure 5.3).

**Figure 5.3 Businesses that identified lack of access to additional funds as a barrier to innovation<sup>a</sup>**

2012–13, by innovation status and number of employees



<sup>a</sup> Does not include non-employed 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 innovative 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 'innovative' businesses that the Commission has used in this report (as detailed in chapter 2) which excludes the adoption of an existing product or process by the business or industry.

Source: ABS (2014f)

Evidence also points to greater amounts of finance being required for innovative start-ups compared with the general new business population. Data from the Comprehensive Australian Study of Entrepreneurial Emergence (CAUSEE) indicates over 60 per cent of high potential businesses seek finance compared to just 25 per cent of 'regular' businesses.<sup>18</sup> 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

<sup>18</sup> The CAUSEE study uses a range of variables to identify whether a business can be classified as high potential. Generally, high potential businesses had much higher expected revenues than other businesses, were substantially more likely to be considered high tech and to apply for intellectual property protection. This suggests that in broad terms, the definition of a 'high potential' business is similar to the definition of 'high growth' businesses as defined in chapter 2 of this report.

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value this result suggests that [high potential] firms are not treated as special cases by external financiers. (Gordon and Davidsson 2013, p. 6)

Further, the source of finance tends to be different for innovative businesses compared with replicative businesses. Several studies suggest that the finance needs of new innovative businesses are more commonly serviced by equity rather than debt (Audretsch and Lehmann 2004; Hall 2010). CAUSEE data also suggests that high potential nascent businesses are less likely than the general new business population to utilise bank debt products (Gordon and Davidsson 2013).

On balance, there is evidence to suggest that innovative new firms do experience greater difficulty accessing finance than businesses who are not undertaking innovative activity. The extent that there is a role for government to address this difficulty depends on the extent that this difficulty is a result of failures in either equity or debt markets, or there are likely to be positive spillover benefits from government intervention. This is explored in chapter 6 (in relation to equity markets) and chapter 7 (in relation to debt).

## 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. Such finance gives the investor a claim to part of the business returns (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).

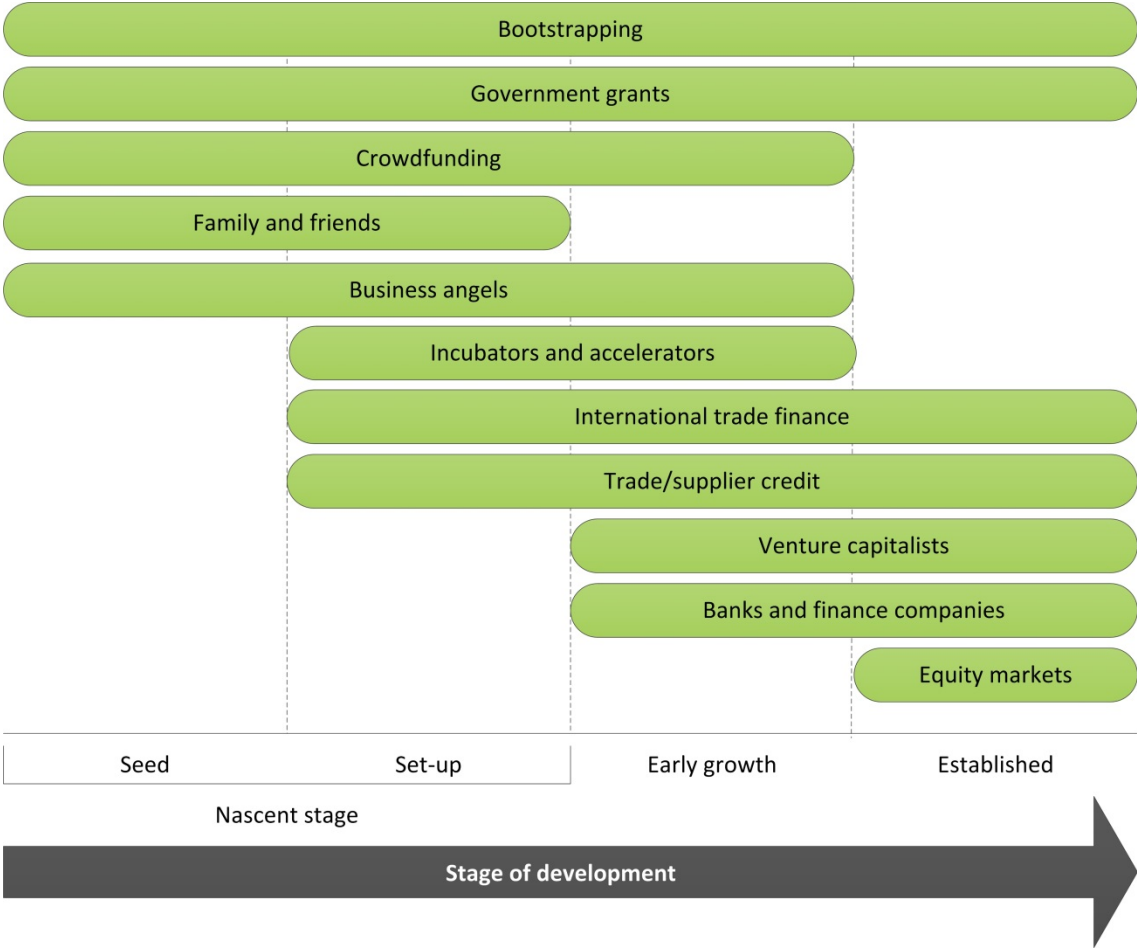
Most new businesses are established — at least in part — through ‘bootstrapping’. This involves a business owner drawing on their existing financial resources to establish their business — including personal savings, personal credit cards and/or equity in personal assets such as real estate. Where larger investments are required, this may be complemented with debt or equity finance from family and friends or other external sources.

The Startup Muster survey (2015) suggests that 37 per cent of funded 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 cost and availability of different forms of finance — on a relative and absolute level influence how much finance new businesses seek from which sources.

**Figure 5.4 Sources of business finance**



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

Another potential source of finance for new businesses is government grants, loans and guarantees. The Australian Government and state and territory governments provide financial assistance to selected new businesses, some of which is targeted to supporting innovative new businesses (chapter 10 and appendix E).

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.

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Crowd-sourced funding is usually undertaken through an online platform — for example Kickstarter, Quirky or Indiegogo — and takes one of 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 the most common 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.

**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, New South Wales. 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 receive 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 less than 40 grams and can include tracking and locating customisations. In three months, it raised over \$US180 000 on Indiegogo from over 2600 backers. Backers could pre-order the product or extra features.

Source: Fitzsimmons (2014)

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For new businesses with an export or import focus, international trade finance can represent 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 international trade credit in detail in its 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 innovative businesses in the early stage of their life. Another source of equity financing for new businesses is employee share schemes. These forms of equity financing are considered in chapter 6.

Loans may be available to new businesses, although typically appropriate collateral (usually residential or commercial real estate but sometimes plant or equipment) and a proven and secure revenue base are 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.

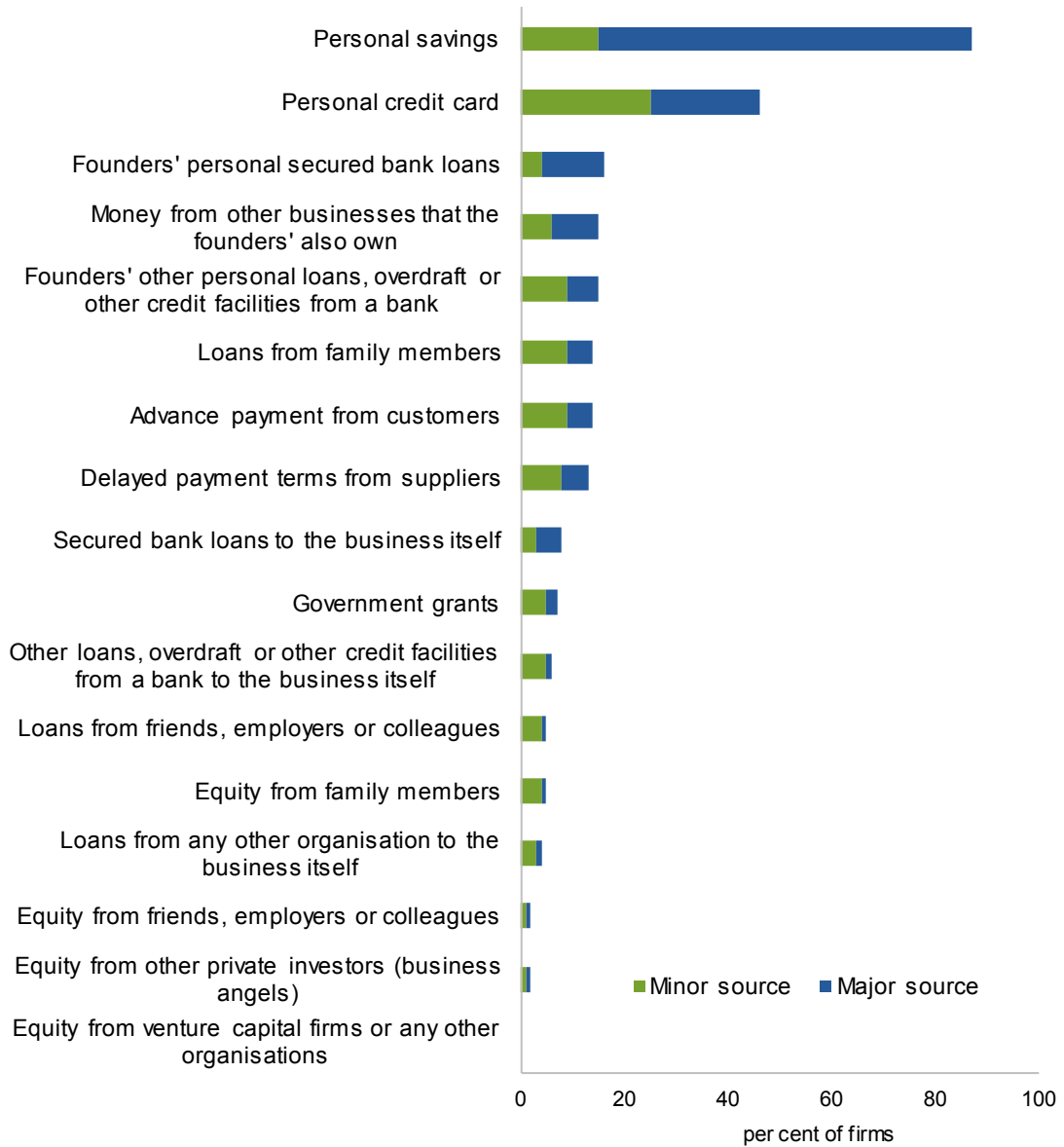
The relative importance of these financing options for nascent businesses in Australia has been explored by Davidsson, Gordon and Steffens (2012). By far, nascent businesses rely most on personal forms of finance — including savings, credit cards and personal bank loans — to finance their start-up. The 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).

Unfortunately, more recent (post GFC) data specific to new businesses are not available. However, analysis undertaken by Matic, Gorajec and Stewart (2012) 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 Australian Bankers Association that indicate that credit cards, overdrafts and long term loans are the most common lending products used by small businesses (ABA 2014). 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 (Startup Muster 2015) (figure 5.6).



Figure 5.5 Sources of finance for nascent businesses<sup>a b</sup>  
2007



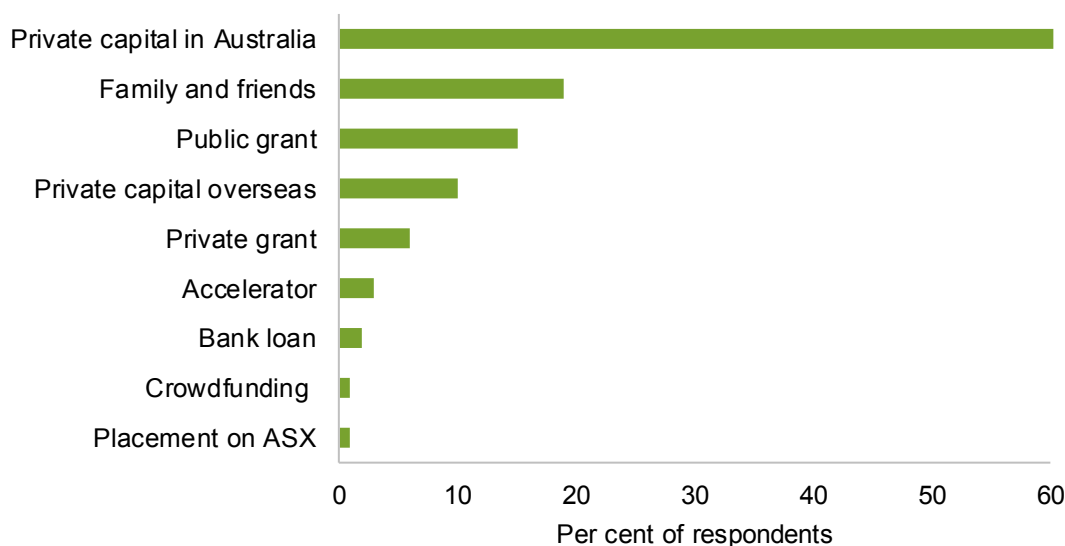
<sup>a</sup> Based on a sample of 625 nascent businesses. <sup>b</sup> A 'major source' of funding is defined as representing at least 20 per cent of total funding needs.

Source: Davidsson, Gordon and Steffens (2012)

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Figure 5.6 **Funding sources used by start-ups** <sup>a</sup>

Results from 2014 Startup Muster survey



<sup>a</sup> Private capital includes personal savings and finance of owner(s).

Source: Startup Muster (2015)

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

Businesses that have considerable uncertainty may find it more difficult to access certain forms of finance, or find the cost of available finance is comparatively high — particularly if a lack of information makes it difficult for investors to understand and quantify the risks involved.

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 use 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 sizable 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.

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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 financiers 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 financiers. Furthermore, a lack of developed markets makes new businesses more susceptible to the volatilities of the business cycle — further diminishing 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 key persons are 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

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when a large corporation is restructured in a way that individual parts become autonomous businesses.

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, new large businesses find it less difficult to source finance than a new smaller business. This is reflected in ABS data that indicate that large businesses are more likely to seek (and more likely to obtain) debt or equity finance 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 Government involvement in new business finance**

By international standards, governments in Australia have relatively limited involvement in promoting finance for new businesses. Specific forms of government assistance to new businesses are explored in detail in chapter 6 (in relation to equity), chapter 7 (in relation to debt) and appendix E (in relation to grants and in lieu government support).

Broadly speaking, however, there are two ways governments can elect to support access to finance by new businesses — provide support directly to the business itself, or support those who invest in new businesses.

### **Support to individual businesses**

Governments may elect to support new businesses by providing grants, concessional loans, transfers and other forms of monetary assistance directly to businesses. Typically, the government's position with such financing is that of a passive investor — the government usually does not hold shareholder rights — but rather the 'payoff' for the taxpayers is seen to be the continued operation (or expansion) of the supported business.

Such arrangements risk exposing the wider community to net welfare losses. Resources diverted to supporting businesses have an opportunity cost associated with them. Further, in instances where support is offered to individual firms — as opposed all firms participating in a particular industry or activity — efficient businesses who can operate without being reliant on government support are effectively penalised.

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## Support to investors

Other forms of assistance emphasise providing support to those who invest in new businesses. An example of one such program is the Small Business Investment Company operating in the United States (box 5.3).

### Box 5.3      **The US Small Business Investment Company Program**

The Small Business Investment Company (SBIC) program was established in 1958 with the goal to help fill the gap between the availability of growth capital and the needs of small businesses. The program is administrated by the US Small Business Administration (SBA) — an independent agency of the federal government.

Under the program, private investment funds can apply to the SBA to operate as an SBIC and are approved on the basis of their investment style, performance and management structure. The approved funds then assess qualifying small businesses, and invest in those businesses deemed as favourable investments. The SBA provides government guaranteed debt to the approved funds that supplements the contributions made by private investors (the SBA may contribute \$2 for every \$1 from private investors up to a capped amount). The SBA's contribution is funded through the issue of debentures. When investments become realised, the approved fund repays the SBA debt and provides it with a share of the profits.

As well as a general (standard) program, funds can be licensed for *Impact Investment* where at least half of investment funds must be in 'impact investments' such as in clean energy or economically disadvantaged areas), or for *Early Stage Investment* (where at least half of the investment must be in early stage companies that are yet to have a positive cash flow).

Between 2010 and 2014, over \$US17 billion was invested under the program, across nearly 6000 small businesses. The Commission was advised that the annual budget allocation for the program has never been fully spent.

*Source:* SBA (2014, 2015)

Compared to support provided directly to businesses, there are some advantages to this approach, namely:

- It allows governments to adopt a portfolio approach to providing assistance. Private investment funds have an incentive to diversify their investments — investing too much in one business is excessively risky. By joining with private investment funds, governments are encouraged to take this approach.
- Private investment funds are only willing to invest if there is an expectation of a positive return. Hence, government funds will only be going only to those businesses that the private sector has deemed likely to be viable.
- The due diligence on which businesses receive investment is undertaken by private investors so governments are not in a position of selecting the individual firms that receive government support. In the case of the SBIC, the only meaningful involvement by the US Government is to assess the eligibility of investment funds and set some broad rules about what businesses should be eligible for government-backed investment.

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## 5.5 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.

### 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 potential businesses are as likely to receive external finance as lower 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 of itself is not evidence that there are 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.

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## 6 Equity finance

### Key points

- There is very limited use of equity finance (other than from the business founders) by new businesses, 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, some type of corporate restructuring activity, or established to undertake a major project development.
- For innovative and high growth potential 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 introduced changes to the existing regulatory arrangements for employee share schemes (ESS) and is establishing a regulatory framework to facilitate crowd-sourced equity funding (CSEF).
  - The recently introduced ESS arrangements should be reviewed by 2020.
  - To facilitate CSEF, the regulatory framework should minimise reporting and compliance obligations placed on issuers and provide adequate protection to smaller investors.
- The Australian venture capital market is relatively small scale and features mainly small funds, providing small amounts of funding to companies with proven products and services or for later stage expansion. There is also a flow of venture capital into Australia.
  - High quality innovative businesses with high growth potential are likely to attract funding irrespective of their location.
  - Difficulties in accessing venture capital funding are *not* indicative of a failure in venture capital markets, but it is uncertain the extent to which innovative ideas that could be commercialised are unable to attract the necessary funding.
- The Australian Government has two tax incentive schemes in place to increase the supply of venture capital. The Venture Capital Limited Partnerships should be closed to new registrations and the Early Stage Venture Capital Limited Partnership should continue. Consideration should be given to the extension of capital gains tax exemptions to individual investors.
- 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 high growth potential 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 by superannuation or any other such funds.

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This chapter looks at the role of equity finance in business set-up, the barriers facing businesses in accessing equity, particularly new and smaller businesses, and options to improve access to equity finance for these businesses including government initiatives to increase the supply of venture capital. Participants pointed to a number of barriers to new businesses accessing equity finance, including: 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 difficulty for some in accessing venture capital.

## 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 and nature of their investment, the investor may have some degree of control over the business, including through representation on the board(s) of the business or in a formal advisory capacity.

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. Equity finance also provides a business with partners with aligned incentives/motivations — for example, to maximise growth in order to increase the value of their investment.

The sourcing of equity finance varies from public listing on stock exchanges (which provides access to a very large number of potential investors, including large institutional investors), to private equity funds, crowd-sourcing and relying on own investment funds or those of family and friends.

### Types of equity finance

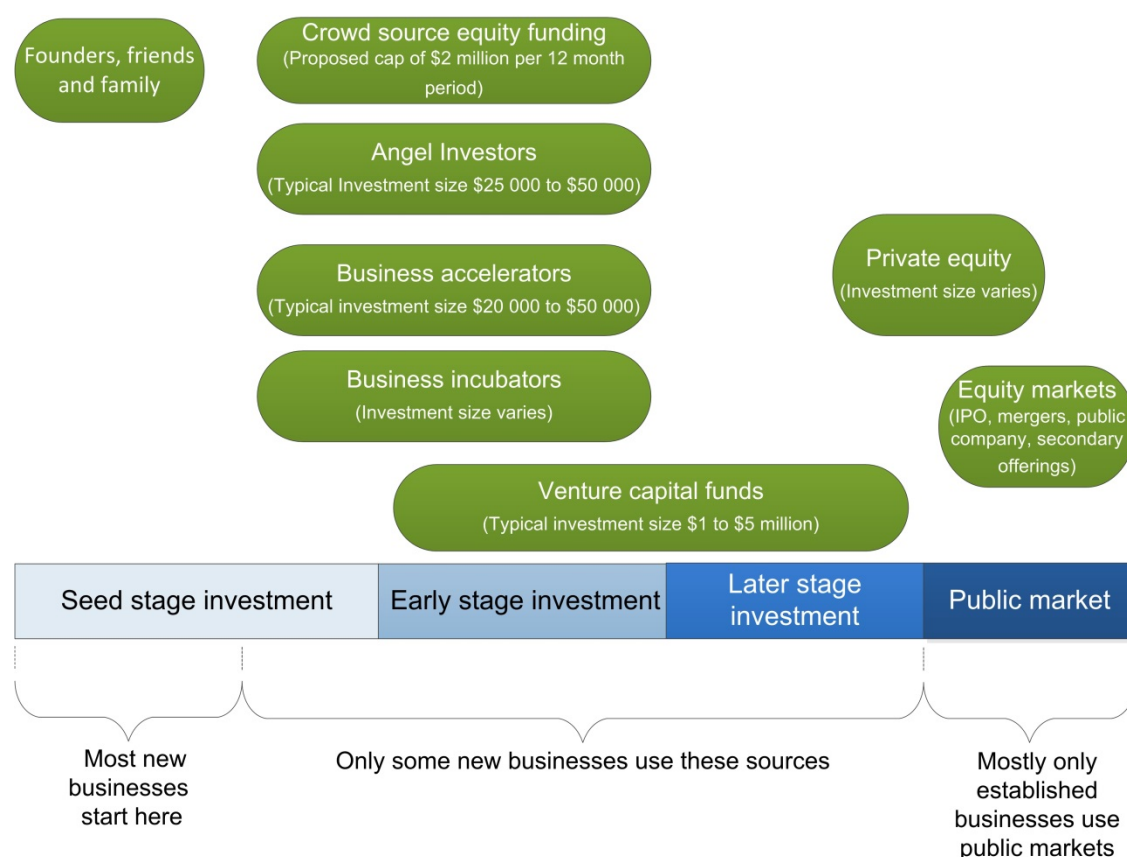
There are a number of types of equity finance used by new businesses:

- *Self-funding/internal equity or 'bootstrapping'*: The savings of the business owner 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.
- *Business angels*: Business angels are wealthy individual investors who invest their own funds, time and expertise into start-ups. Angels are usually only interested in innovative new businesses not the vast majority of replicative small businesses. These individual investors often have extensive experience in setting up a business and in investing and generally have a close involvement in the operation of the business. Mazzarol (2012) notes that investment by business angels provides the means to bridge the gap between



funding by the founder of the business, friends and families and funds provided by venture capital investors as a business grows (see figure 6.1). This funding is often referred to as ‘pre-seed’ or ‘seed’ funding as this very early investment typically supports the business in the initial concept development until it can generate a cash flow or is ready for further investment. There is no regular data collection on the size of funds invested by business angels.

Figure 6.1 **Equity investors and the investment stages of business growth**



Source: Derived from OECD (2012a)

- *Venture capital:* Venture capital funds invest either directly in investee companies or indirectly through pooled venture capital funds or aggregators, in return for an equity share. These funds tend to invest in high-risk and high-return innovative ventures that are unlisted, and therefore have few other parties with which to share risk and return. 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 process.

There are series or stages of venture capital investment — the definitions of the different stages, the progression of businesses through them and the amounts typically

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invested in each vary by sector and country. The initial institutional financing round undertaken by venture capital investors is often referred to as the ‘early stage’, ‘start-up stage’ or ‘A series’ investment where the business is beyond the seed stage and focused on product development and initial marketing. This can be followed by a further round of funding or ‘B series’ investment where the business is in place, has completed product development and may be producing some revenue (the business has gained ‘traction’) and later stage or ‘C series’ investment where the product and/or service is commercially available and the business is intending to expand rapidly. Typically, each stage or funding round provides the additional capital to enable the business to advance to the next stage of development.

Equity provided by venture capital funds can represent a significant stake in a business. As such, providers of venture capital typically exert a considerable degree of influence or 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).

- *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 fund development of innovative business ideas that have had difficulties in accessing funds from more traditional sources. CSEF is considered to be a relatively low cost means for small businesses to attract equity funding. As well as providing an alternative source of funding for small businesses, it can provide an opportunity for retail (‘mum and dad’ type) investors to invest in early stage financing activities without having to make a large investment (The Treasury 2014a). However, due to its potentially large number of small investors, CSEF will only meet the funding needs of some types of new business (and typically only those that are able to readily capture the investment interest of a ‘crowd’). 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 new funds, these schemes reduce early cash flow demands on the company. By providing employees access to the future profits of 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 new small businesses as they can be used to attract and retain highly skilled staff without drawing on scarce funds and have become an integral part of the remuneration arrangements of the start-up sector globally. Governments in Australia and overseas have provided preferential tax and regulatory arrangements around such schemes to encourage their use (The Treasury 2014b).
- *Business incubators and accelerators*: Business incubators and accelerators host prospective start-ups and locate them in a central physical location with other start-ups. In addition to providing office space, mentoring and support, business incubators and accelerators can provide funding in return for equity. For example, the Muru-D

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accelerator 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 (Muru-D 2015). The role of business incubators and accelerators is discussed further in appendix E.

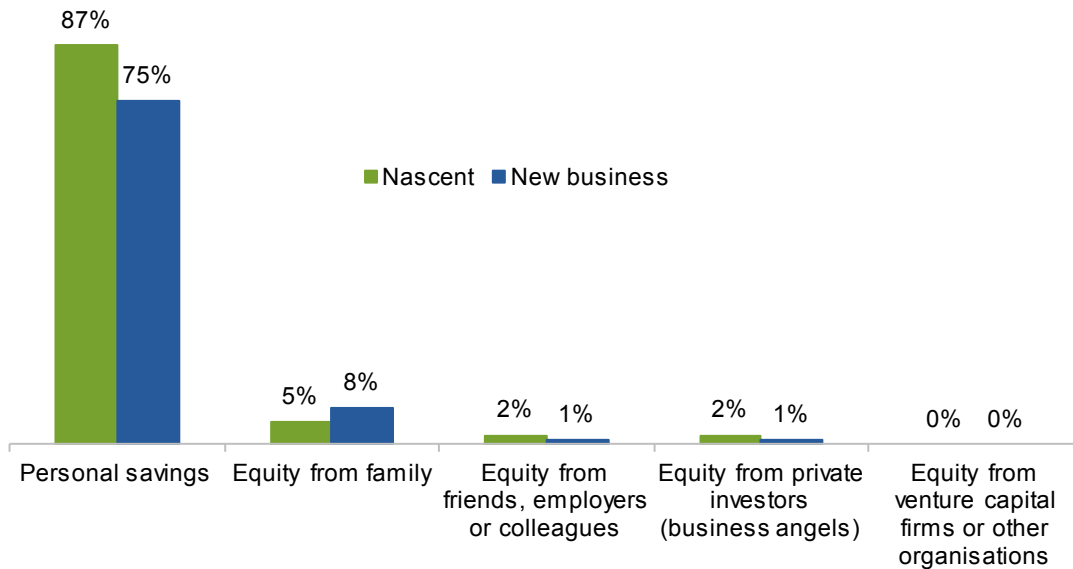
There is also equity financing that is more typically associated with established businesses, although some forms (such as ESS) cross over between new and established business:

- *Private equity*: Private equity covers professionally managed funds and investors that make investments in private companies or ‘buy outs’ of public companies that are then delisted. Private equity investment is usually focused on established businesses — for example, it includes investments made in businesses that are in distress in order to turn the business around before an IPO listing or selling off of the business. It can also provide a conduit by which large business activities can be restructured and ownership transferred. Many infrastructure privatisations in Australia have been done as ‘trade sales’ which can be seen as private equity transactions. Later stage private equity investments were valued at \$6.2 billion at the end of 2013-14, accounting for 0.4 per cent of Australia’s GDP (ABS 2015a).
- *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, the Australian Securities and Investments Commission (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
  - 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).

### **How important is equity finance?**

There is very little use of external equity finance by the vast majority of 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). In aggregate, as noted in chapter 5, (external) 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. Survey data from the Comprehensive Australian Study of Entrepreneurial Emergence (CAUSEE) indicates that where external equity finance is sought, it is mainly sourced from family and friends (figure 6.2).

Figure 6.2 Nascent and new businesses use of equity finance<sup>a,b</sup>



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

Source: Davidsson et al. (2012)

As Davidsson et al. (2008) noted:

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 (p. 6).

Also, most are likely to be micro-businesses that do not have the time, experience and funds to approach potential investors outside of family and friends. What is not clear is the extent to which any barriers, perceived or otherwise, to equity finance access might be discouraging businesses from investigating it as a financing option.

It is worth noting, however, that the experience in Australia is not unique. 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). 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 external equity finance was very low.

Equity finance is important for those businesses seeking to expand rapidly

The very small proportion of businesses that do seek external equity funds at an early stage often do not have the assets or income necessary to secure a bank loan, but are developing

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an innovative idea with the potential to be a high-growth business. Gordon and Davidsson (2013) 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. For these businesses, access to external equity funding is likely to be crucial for developing the new product or service to the point where commercial viability can be demonstrated.

In addition to the innovative start-ups, 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 Government and state and territory 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).

## **6.2 Crowd-sourced equity funding: what is the right regulatory framework?**

The regulatory framework to enable CSEF to occur is not yet in place — the Government is currently examining options to determine what regulations are necessary. This follows 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 (The Treasury 2014d) 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 (the crowd) 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 was to get the 'regulations right' to enable CSEF to occur. This requires balancing the needs of small and medium businesses to more easily access funding by reducing compliance costs, while ensuring that adequate investor protections are in place. CPA Australia said:

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

## **The regulatory models are being considered by Government**

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 Treasury then released a further discussion paper in August 2015 that outlined the regulatory arrangements for public companies to access CSEF and proposed separate regulatory arrangements for proprietary companies to access CSEF (The Treasury 2015a). (Some examples of the regulatory models used in other countries are provided in box 6.1.)

### **The CAMAC model**

The CAMAC model allows eligible new small businesses to become ‘exempt public companies’ when seeking CSEF. These businesses are exempted from the disclosure and reporting obligations that are normally placed on public companies. Existing proprietary companies and some smaller public companies would be most likely to be able to satisfy requirements to be an exempt public company — only unlisted companies with a simple structure that have not already made a public offer and are within the capital and turnover caps would be eligible to conduct a CSEF issue and remain exempt from the full disclosure requirements. The exemption would automatically lapse if the annual turnover of the company exceeded a predetermined minimum (a suggested \$5 million per annum) or the capital of the company reached a certain stipulated threshold (a suggested \$5 million for continuous period of 6 months). Businesses would be limited to raising \$2 million per 12 month period to remain exempt from the disclosure requirements.

CAMAC also proposed arrangements to protect investors. Retail 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. There is also a requirement for investors to sign a risk acknowledgment statement and a cooling off period (suggested at five working days) to allow investors to withdraw from a share acquisition through CSEF. 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**

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 that exists for 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

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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.

### Separate regulatory frameworks for public companies and proprietary companies to access CSEF

In August 2015, the Treasury outlined key elements of the Government's proposed regulatory framework for public companies to access CSEF and put forward for consultation regulatory options for proprietary companies to access CSEF (The Treasury 2015a). This approach is based on separate regulatory frameworks for public companies and proprietary companies to access CSEF.

For public companies, access to CSEF would be limited to those public companies that have not raised funds under existing public offers. These companies would be exempt from certain public company compliance for up to five years subject to remaining under gross asset and annual turnover thresholds of \$5 million. An issuer cap of \$5 million would apply, with an investor cap of \$10 000 per offer and \$25 000 in aggregate per year. Other investor protections included a five day cooling off period and a risk acknowledgment statement for investors. For intermediaries there would be no restrictions on fee structure, but fees paid by the issuer would be required to be disclosed. Intermediaries would also be able to invest in issuers using their platform provided such investments were disclosed.

For proprietary companies to access CSEF, the consultation paper put forward the option of increasing the shareholder limit (from 50 to 100 non-employee shareholders) on these companies. It also proposed an alternative approach to increase the shareholder cap for a limited period of time to allow access to CSEF consistent with the exemption for public companies (the exemption would remain for a period of up to five years subject to gross assets and turnover remaining below \$5 million). Proprietary companies would also be required to undertake additional transparency and reporting obligations similar to those applying to public companies engaged in CSEF. A similar fundraising cap as applied to public companies was proposed, but there was no discussion on whether or not a similar investor cap would or should apply (The Treasury 2015a).

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## Box 6.1      **How CSEF is regulated in other countries**

**Canada:** Proposals to facilitate CSEF in Canada 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 on 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 countries 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)



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## Concerns around the caps on investors

All regulatory models under consideration by the Australian Government include caps on investors and issuers. Participants to this inquiry raised a number of issues around these caps and their implications for either the ability of issuers to raise funds or the attractiveness of CSEF to investors (The Treasury 2014a).

### The caps are aimed at reducing the risks associated with CSEF

The proposed caps are to protect investors from some of the risks associated with CSEF. ASIC (sub. 20) commented that there were 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 was also the risk of business failure, particularly where the funded business model was unproven, the operator lacked experience or had 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 were increased where investors lacked the necessary experience and knowledge.

CAMAC (2014a) noted that if retail investors, with low financial literacy and or/capacity, were to suffer significant losses the ‘confidence of the crowd’ could be undermined placing the overall viability of CSEF as a source of funding at risk.

### Can access to CSEF be improved and investors protected?

Although intended by Government to protect investors, the proposed caps on 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. The caps under the CAMAC model, for example, effectively limit an investor to four CSEF investments each year — each investor would be 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 Treasury consultation paper proposed a \$25 000 per year aggregate cap and a \$10 000 per CSEF issuer cap for investors in exempted public companies.

There are problems with an investor cap that 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-ups. However, for larger more sophisticated investors better able to assess the risk of various investments, the use of a cap may act as 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.

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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).

The capital raised from sophisticated and professional investors should not be included in any cap placed on issuers. As sophisticated and professional investors would be able to invest in such companies independently of any CSEF offer under the existing exemptions in the Corporations Act, CAMAC noted that it would not be in the interest of issuers, or their crowd investors, to limit funding from these sources. The Treasury consultation paper similarly endorsed excluding these investors from any issuer cap (The Treasury 2015a). A similar approach is used in New Zealand where funds obtained from wholesale investors are not included in the annual \$2 million cap on issuers (CAMAC 2014a). ASIC, in its response to the Commission's draft report, also held that funds raised from these investors should not be included in any cap placed on issuers (sub. DR. 58).

As to the adequacy of the cap placed on issuers, CAMAC found that a \$2 million cap, similar to that in place in New Zealand, would suffice for the majority of start-ups to prove their concept on a small scale and attract further capital outside of CSEF to further develop their business.

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 all the proposed regulatory frameworks). 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. Although the New Zealand model takes a more 'light handed' approach as to the protection of investors (and in the regulation of intermediaries), companies are subject to a cap on the funds they can raise.

Alternatively, the UK model — being limited to a particular class of investor — is an option to protect many retail investors from some of the possible risks. However, as noted by CAMAC, limiting investment to particular classes of investors will not facilitate funding from the 'crowd' (CAMAC 2014a).

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

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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. ASIC endorsed exempting such investors from any cap and supported the Commission's recommendation in the draft report to use a two-tiered regulatory structure in regard to investor caps (sub DR. 54).

In regard to other key aspects of the future arrangements for the facilitation of CSEF, the Commission supports:

- The establishment of a single corporate form as proposed by CAMAC (the exempt public company) and the associated proposed regulatory framework to facilitate access to CSEF rather than have separate frameworks for public companies and proprietary companies. This model recognises that an entity making offers to the public (the online crowd) should be regulated as a public company, but with reduced compliance requirements initially to encourage the use of this form of capital raising.
- Allowing an issuer (at the end of the prescribed exempt period) the option to revert to a proprietary company structure. Clearly there would be practical difficulties for an issuer after a successful crowd funding to reduce the number of non-employee shareholders to 50 to meet the legislative requirements of a proprietary company, but those issuers that may be less successful in conducting a CSEF would not be mandated to continue as a public company.
- The regulation of intermediaries (as proposed by CAMAC) to support issuer and investor confidence in the CSEF process including being licenced by ASIC, but without restrictions on intermediaries having a financial interest in an issuer and their fee structures. Intermediaries would be subject to full disclosure of their fee structures and any financial interest in the issuers as outlined by the Treasury consultation paper.
- A regulatory framework to protect investors, including cooling off periods, acknowledgment of risk and the exclusion of sophisticated and professional investors from caps on investors.
- An issuer cap of \$5 million (excluding funds raised by sophisticated and professional investors) and an investor cap of \$25 000 per year and \$10 000 per issuer as outlined in the Treasury consultation paper, recognising that such caps are arbitrary and should be adjusted in light of experience with the operation of CSEF.
- A review of the CSEF arrangements after they have been in operation for 5 years.

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#### RECOMMENDATION 6.1

The Australian Government should introduce arrangements to facilitate crowd-sourced equity funding based on:

- a single corporate form (the 'exempt public company') — as proposed by the Corporations and Markets Advisory Committee (CAMAC) in its *Crowd sourced equity funding* report — with the ability to revert to a proprietary company where the entity meets the legislative requirements following the exemption
- the regulation of intermediaries as proposed by CAMAC, without the proposed restrictions on intermediaries having a financial interest in an issuer or on their fee structures, but with full disclosure of intermediary interests
- a regulatory framework to protect investors, including cooling off periods, acknowledgment of risk and a cap on those investors that are not 'sophisticated' or 'professional' investors as defined under the *Corporations Act 2001* (Cth)
- an issuer cap of \$5 million per year (that excludes funds raised from sophisticated and professional investors) and an investor cap of \$25 000 per year and \$10 000 per issuer as proposed in the Treasury consultation paper, but recognising that such caps are arbitrary and should be adjusted in light of experience with the operation of crowd-sourced equity funding.

### 6.3 Employee share schemes: new arrangements for access

The Australian Government recently introduced legislation to encourage the establishment and growth of small businesses by making specific changes to the taxation of ESS including:

- changing 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 businesses 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 2015g).

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The intention of Government in making these changes 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 businesses. The additional tax concessions target those small businesses with limited cash resources and little access to capital, to assist them to attract and retain highly skilled staff, especially where there is a highly competitive global market for such staff.

In particular, the 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. These eligibility requirements — that include all affiliates and associated companies — are to ensure the integrity of the arrangements. In excluding listed companies from the concessions, the exposure draft noted 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 likely to be less problematic (Australian Government 2015g).

These changes, in particular taxing the share options of employees when they are exercised instead of when they are granted, aim to address major stakeholder concerns of the previous arrangements and may enable Australian small businesses to compete with other countries to attract and retain talented staff. Google, in endorsing the Government's proposed changes, noted that:

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**

In the draft report, a number of concerns were raised regarding employer eligibility to the tax concessions to assist small businesses. These focused on:

- using an annual turnover cap of \$50 million to determine the size of the business
- requiring a business to be 'younger' than 10 years old
- excluding listed companies

In the Commission's view, 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. Requiring a business to have fewer 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 businesses to attract and retain staff. The use of the \$50 million turnover cap could exclude smaller businesses with large turnovers, but slim margins. The Commission has previously concluded that as it is not

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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 2013c). However, a starting point to determine eligibility as a small business is to use the ABS definition of a small business — that is, a business that employs fewer than 20 people. This definition is also used by the Australian Government’s Small Business Commissioner.<sup>19</sup>

The requirement for businesses to be incorporated for less than 10 years provides for the concessions to be limited to ‘new’ businesses. Indeed, a lower ceiling on the period of incorporation may be sufficient to define a new business — it is unlikely that many investors would consider a business incorporated for 10 years to still be ‘new’.

The Commission agrees with the exclusion of listed companies as this limits the concessions as intended to those businesses more likely to have difficulty with access to capital. The Commission also supports applying the employer eligibility criteria to affiliated and associated entities to ensure the overall integrity of the arrangements (Australian Government 2015).

### **Cessation of employment remains a deferred taxing point**

The recent changes made to ESS allow for the ‘cessation of employment’ to be a deferred taxing point. Several submissions (for example, the Law Council (2015)) on the draft legislation 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.

The Commission examined concerns around the ‘cessation of employment’ as a deferred taxing point for ESS in its inquiry into executive remuneration in Australia. 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.

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<sup>19</sup> In the European Union, a small business has fewer than 50 employees, in Canada it is a business with fewer than 99 employees and in the United States it is fewer than 500 employees in manufacturing businesses and fewer than 100 in wholesaling.

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Under the Government's new arrangements, employees will continue to be subject to paying tax on unvested shares or rights when ceasing employment. Tax cannot be deferred indefinitely as there are time limits 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 would be some taxation integrity issues about removing cessation of employment as tax deferral point, such issues are considered not to be insurmountable (PC 2009b).

### **Can ESS tax concessions be justified?**

The Early Impact Assessment estimates that the proposed ESS arrangements — the deferral of tax payable and the tax concessions to employees of small unlisted businesses — will have a \$200 million cost to revenue over 4 years (The Treasury 2014b).

From a tax-neutral perspective, the Commission considers that income tax on equity based payments should be applied at the time the rights, options or shares are granted (PC 2009b). However, due to the Government's policy intention to provide preferential tax treatment of employee share ownership and the difficulties in valuing performance contingent unlisted rights, deferral of tax is 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 useful to new businesses with limited cash resources in enabling them to attract and retain staff. Indeed, the Commission was told by a number of participants that given the differences in salaries offered to coding staff by Australian and United States employers, without an ESS of some form, it will be very difficult to keep skilled Australian coders in the country, let alone attract them from abroad.

The Commission recommends that the ESS be reviewed to assess its effectiveness in meeting its objectives and its benefits relative to the revenue costs by June 2020.

#### **RECOMMENDATION 6.2**

The effectiveness of employee share schemes and the costs and benefits to the broader community of their concessional taxation treatment should be reviewed by 30 June 2020. The review should consider:

- the use of additional tax concessions for small start-up companies and the eligibility requirements to access these tax concessions
- the removal of the cessation of employment as a deferred taxing point for equity or rights granted by an employer.

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## 6.4 Company listing: are the costs prohibitive?

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 as an issue by inquiry participants.

The Corporations Act (s708) 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). 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 (ASIC 2014c).

### Should the disclosure requirements be further lowered?

The preference of listing companies to issue a prospectus is a result of companies seeking to encourage participation in the offering by enhancing investor confidence. Companies 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. It also enables the issuer to take advantage of the relevant due diligence defences available under the prospectus regime (ASIC, sub. 20).

ASIC considers that, given the evident preference of small companies to use prospectuses when raising equity, further lowering the standard of disclosure would not stimulate equity investments in smaller companies (ASIC 2014c). In addition, the costs associated with a loss in investor protection from a further lowering may exceed the reduction in administrative costs associated with capital raising (sub. 20).

In the Commission's view, there does not appear to be any rationale or evidence to support a lowering of the standards of disclosure required to raise equity.

### Reverse takeover or backdoor listing

Businesses can also list on the ASX through a reverse takeover or backdoor listing. This involves a non-listed company purchasing or merging with an ASX listed company that may be struggling or simply a shell and no longer trading. There has been a trend recently for technology companies to list through dormant or struggling resource companies. This can ensure that the ASX aspirant is able to secure the required minimum number of shareholders from the existing listed company without having to go through an IPO. It also provides an opportunity for the existing shareholders to access or unlock some of the value of the listed company. Where the listed company and ASX aspirant are in the same or a similar business, such arrangements are similar to a merger or acquisition. In 2014, there were 109 ASX listings and 30 backdoor listings on the ASX.



There may be some savings relative to conducting an IPO, although the due diligence requirements have to be applied across two entities rather than one. The use of such a listing still requires similar requirements around disclosure as an IPO including the issuing of a prospectus (unless the listed company and the ASX aspirant have similar businesses) and the approval of shareholders. ASIC has expressed concern that some of these listings have not provided adequate financial reports, that the disclosure of future business plans was sometimes insufficient and questioned the independence of reports on asset valuation and future capital needs (Minter Ellison 2014).

## Costs of listing on the ASX

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.

Listing on the ASX, including underwriting and prospectus preparation, usually costs 6 to 10 per cent of the funds raised, in addition to ongoing annual fees (ASX 2015). There are also specific admission criteria 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).

The costs associated with, and the eligibility requirements for, listing on the ASX were not identified as being a problem for businesses by participants in this inquiry. The Commission was told that template documents are used by some issuers to keep costs under control whereas other businesses and their directors take 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.

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

<i>Admission criteria</i>	<i>ASX</i>	<i>NSX</i>
Number of shareholders	Minimum of 400 shareholders at \$2 000, or 350 shareholders at \$2 000 with 25 per cent held by unrelated parties, or 300 shareholders at \$2 000 and 50 per cent held by unrelated parties.	Minimum of 50 shareholders at \$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	\$500 000 minimum market capitalisation

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

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## The use of secondary boards

One option that may assist smaller companies to access equity markets is through the use of secondary boards.

There are secondary boards in Canada and the United Kingdom that cater for smaller listed companies. Australia experimented with secondary boards between the late 1980s and early 1990s, but they did not ‘gain traction’ with smaller listed companies or investors and were closed. The Commission was advised by some stakeholders that to be listed on a secondary board was viewed as being ‘outside the main game’. 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).

The Commission notes that there was no support from participants for the ASX to re-establish a secondary board on the major Australian equities market. One reason for this may be that such a board would potentially overlap with the NSX (National Stock Exchange of Australia).

The NSX, re-established in 2000, specialises in smaller listings and has around 100 companies currently listed. The cost of listing on the NSX using a prospectus, is typically between 5 and 10 per cent of the funds raised (NSX 2015). There are also ongoing annual fees that vary with market capitalisation. The admission criteria to list on the NSX are not as onerous as those for listing on the ASX (table 6.1).

## 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<sup>20</sup>.

The regulations around equity raising by private companies and the related disclosure requirements, except in relation to CSEF, were not raised as an issue by participants.

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<sup>20</sup> 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.

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## 6.5 Venture capital: how accessible is it?

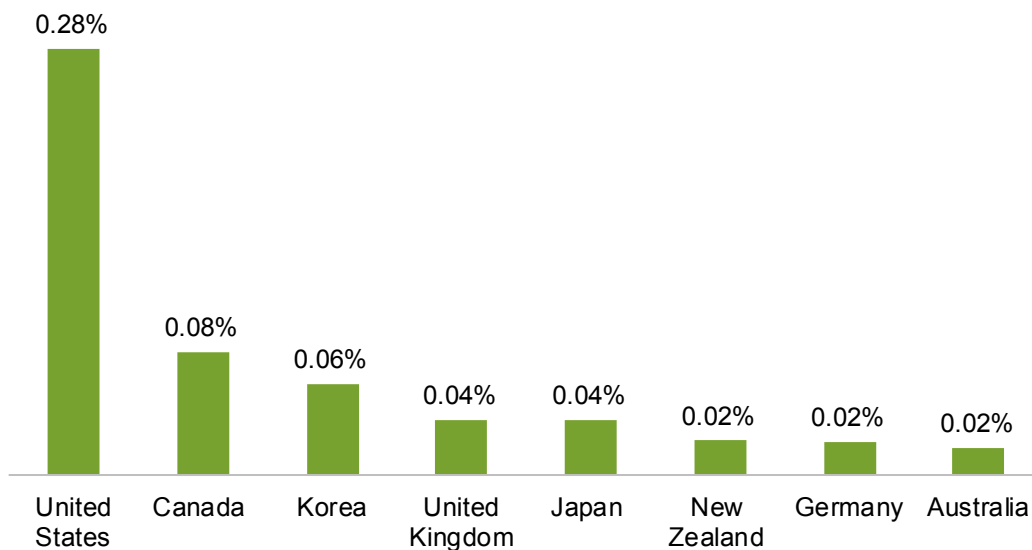
### Is there an adequate supply of venture capital in Australia?

The importance of equity finance to start-ups seeking to grow rapidly, raises the issue of whether there is an adequate supply of venture capital in Australia.

As is the case for all other OECD economies, Australia's venture capital sector is dwarfed by that of the United States. Australia's venture capital sector is one of the lowest (in terms of venture capital investment to GDP) in the OECD. It is also important to note that venture capital investment represents a only a tiny share of GDP in all countries, including the United States (figure 6.3).

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Figure 6.3 **Venture capital investment as a share of GDP, selected countries<sup>a</sup>**  
2014



<sup>a</sup> Japan data is for 2013.

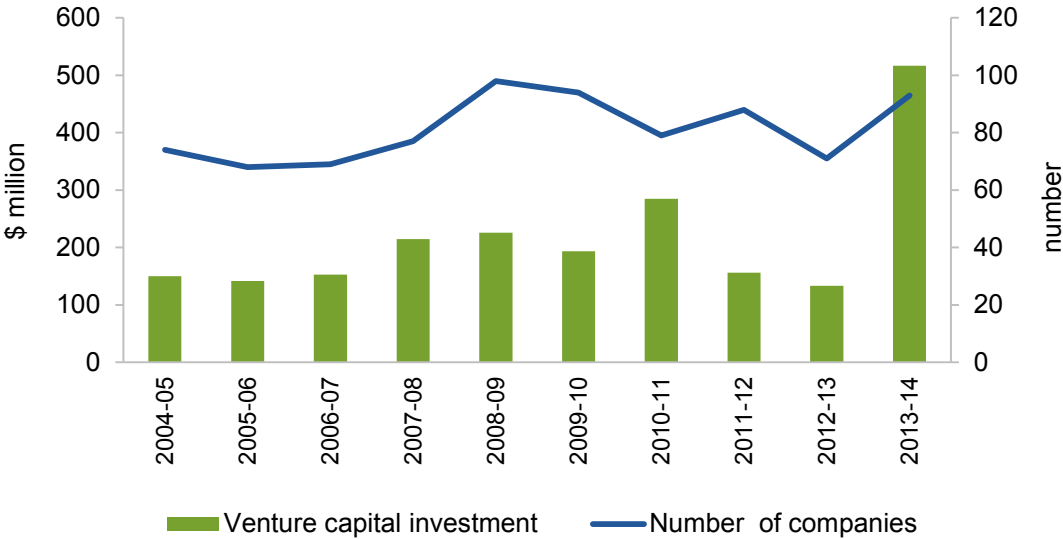
Source: OECD (2015a)

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Funds for venture capital declined both in Australia and in other countries following the global financial crisis. (The Treasury and Department of Industry, Innovation, Science, Research and Tertiary Education 2012) (figure 6.4). However, the most recent year of data (2013-14) show a substantial increase in venture capital investment in Australia — largely the result of one investment (AU\$266 million) by a US-based venture capital fund in an Australian based email marketing campaign developer (AVCAL 2014a). This single investment was nearly 10 times the size of the average Australian venture capital fund.

However, as noted by the Australian Private Equity and Venture Capital Association Limited (AVCAL), even excluding this single investment, venture capital investment was nearly 90 per cent higher in 2013-14 than in the previous year (AVCAL 2014a).

**Figure 6.4 Annual investment of venture capital in Australia<sup>a</sup>**  
2004-05 to 2013-14



<sup>a</sup> Current values converted to 2013-14 values using the implicit price deflator for private total business investment (ABS cat no. 5206).

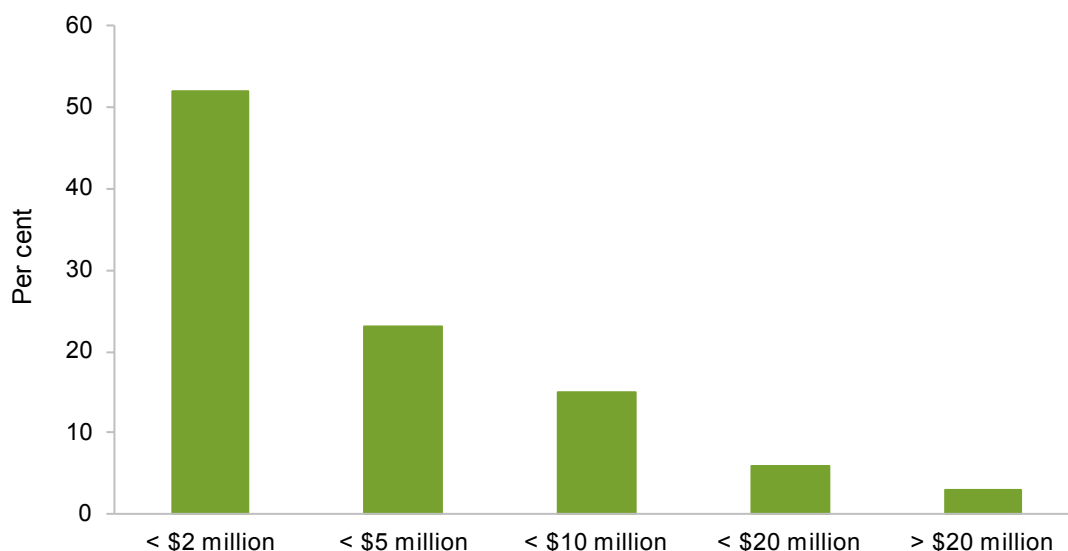
Source: AVCAL (2014a)

More typically, venture capital investment in Australia is generally skewed towards smaller investment amounts. Over half of all venture capital investments in recent years have been under \$2 million and nearly a quarter were between \$2 million and \$5 million (figure 6.5).

These investment amounts reflect the size of Australian venture capital funds. Of the 61 venture capital only funds in Australia, 40 had assets below \$10 million, 11 had assets between \$10 million and \$25 million and only 11 had assets over \$25 million (ABS 2015a). AVCAL (sub. DR72) commented that there had been a thinning of funding capacity in Australia for larger size rounds that was reflected by the fact that only one later stage Australian venture capital fund (of \$200 million) had been raised in the past four years.

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**Figure 6.5 Venture capital funded businesses by deal value**  
2009-10 to 2013-14



Source: AVCAL (sub. DR72)

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Despite this, the Commission has been presented with no evidence of any regulatory impediments that would inhibit the Australian venture capital market in responding to emerging opportunities. To the contrary, a number of new venture capital funds have emerged in recent years — for example, two major Australian banks recently announced the establishment of \$50 million venture capital funds to invest in fintech.

Nevertheless, the relatively small scale of the Australian venture capital market means that those businesses seeking large amounts of investment (\$5 million or more) may face difficulties in sourcing larger investment amounts from Australian venture capital funds. The Commission was told that the Australian venture capital market meets the needs of those companies with a focus on the domestic product market whereas those companies with a global sales focus tend to look to the United States for venture capital.

The small size of the sector in Australia relative to the United States has encouraged some Australian entrepreneurs to relocate there to seek venture capital. Not only is there scope for larger venture capital investments in the United States, but the number of venture capital deals is substantially above the number in Australia (table 6.2). With many investment opportunities to choose from, some US funds require that the start-up be based locally to receive funding and the funds are at times reticent to look outside the United States or even their surrounding region for start-ups to invest in. However, the relocation to the United States by some start-ups is underpinned not only by the relatively larger venture capital market, but also the larger scale market for all products and services in the United States and the greater potential for accelerated growth. Entrepreneurial ecosystems in the United States also offer larger networks of expertise and business and investor contacts,

and for some very early stage companies, these aspects are as much of a drawcard as is the relatively larger venture capital market.

**Table 6.2 Comparing venture capital in the United States and Australia 2013-14**

	<i>United States</i>	<i>Australia</i>
Venture capital under management (\$US billion)	156.5	1.8
Average venture capital fund size (\$US million)	129.8	26
Average venture capital investment (US\$ million)	9.2	1.7 <sup>a</sup>
Number of venture capital deals per million people	13.5	3.4
Number of venture capital deals per million businesses	148.8	35.2

<sup>a</sup> Average fund size 2008–2012.

Source: National Venture Capital Association (2015); AVCAL (2013, 2014a, 2015), (ABS 2015a); Thompson Reuters and National Venture Capital Association (2015)

There is also a flow of venture capital into Australia (as evidenced by the substantial US fund investment in 2013-14, highlighted above). However, the amount of venture capital sourced from outside Australia varies substantially from year to year. Just under half of all new venture capital in 2013-14 was sourced from overseas, around 10 per cent in 2012-13 and 2011-12, but more than half in the previous year (2010–12) (sub. DR72).

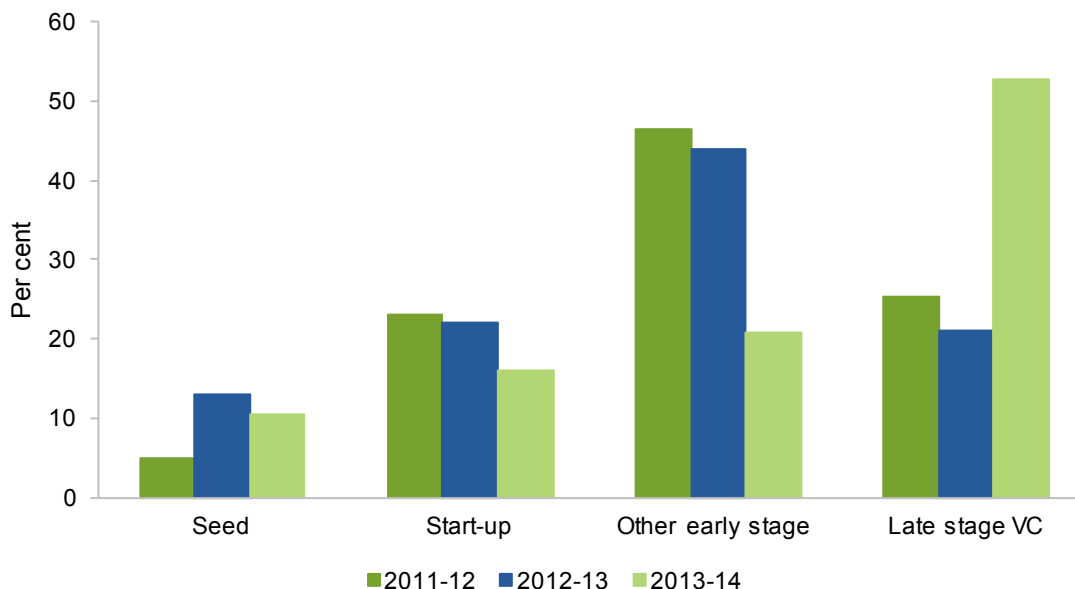
Those Australian-based businesses that have attracted investment from overseas based funds are considered ‘high quality deals’ by investors and are the most likely to attract funding irrespective of their location.

The Commission found conflicting views on the ease with which Australian-based businesses seeking venture capital are able to get funding. AVCAL stated that there had been a ‘drying up of funds’ available for investment and little to no growth in the number of companies receiving venture capital investment.

The number of companies receiving VC investments has remained flat at around 80 to 90 p.a. over the last 10 years, with a significant proportion constituting follow-on investments rather than new investments. (sub. DR72, p. 3)

Stakeholders consistently advised that it is more difficult to attract the initial institutional venture capital investment in Australia to develop a business, than it is to attract the seed stage funding from business angels and individuals to transform a concept into a business. It is in the search for these investors that contacts, networks and introductions become important for start-ups. The data on venture capital investment appear to support this view (figure 6.6).

Figure 6.6 **Distribution of venture capital investment, by stage of investee business<sup>a</sup>**



<sup>a</sup> The data for 2013-14 exclude the one-off \$266 million investment made by a US fund.

Source: AVCAL (2014a)

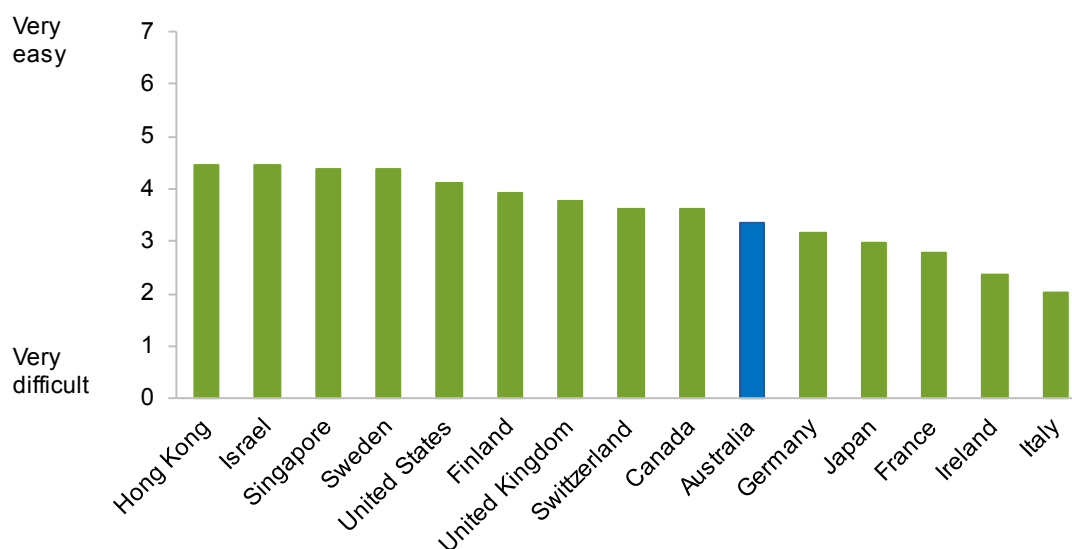
Despite the concerns that venture capital funds in Australia are not available for a range of start-ups, Australia does not appear to be out-of-step with some other countries in terms of the ease of attracting venture capital (figure 6.7).

To the extent that venture capital is focused on businesses with a proven product or service or those requiring expansion capital, this would be consistent with the comparatively small size of Australia's venture capital funds. It is difficult for a small fund to diversify its risk through multiple investments and so investing in more mature businesses is an alternative approach for lowering the overall risk of the fund.

Venture capital funds, on the other hand, often report that there are not enough quality start-ups to invest in (Drummond 2013). Reflecting the view that there are 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)

Figure 6.7 Ease of getting venture capital funding, selected countries <sup>a</sup>



<sup>a</sup> The data are based on a 2012 Executive Opinion Survey 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)

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)

The Commission found widespread acceptance overseas that the value of a start-up (and therefore its attractiveness as an investment) lies not so much with the innovative idea that has given rise to the business, but rather, in its demonstrated capacity to develop that idea on a commercial basis. Once this view becomes more accepted within the Australian start-up community, expectations of what venture capital will fund may become more realistic.

On balance, the Commission has concluded that some start-ups (especially those in a very early stage of development) do face difficulties and are unable to access venture capital and that this can happen for a range of reasons — it can be due to investors considering the



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likely returns relative to the risk and due diligence required are too low, a lack of understanding or insights as to the viability of the business and being exposed to incomplete business plans and/or poorly delivered pitches. In this regard, business incubators and accelerators — by intensively scrutinising firms before providing equity capital or providing links to angels or venture capital funds — play an important role in bridging network gaps and in helping address informational asymmetries. The role of incubators and accelerators is discussed further in chapter 10 and appendix E.

Ultimately though, just because every start-up does not receive the venture capital it seeks does not of itself indicate there is inadequate pool of venture capital funds available. Indeed, if every start-up received venture capital, that would likely indicate that venture capital funds were not undertaking the necessary due diligence. It is, however, not possible for the Commission to determine the extent to which start-ups that would otherwise develop into commercially successful businesses are not being funded.

### **There is a reluctance to allocate funds to venture capital**

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

For example, AVCAL noted that although the domestic superannuation industry is worth around \$1.75 trillion, only a fraction of these funds are allocated to be invested in small business and innovative and high growth 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 2014b).

Superannuation funds can invest in venture capital either through venture capital funds or as a direct investor in a business. Given the relatively modest amount of finance required by a start-up, most superannuation funds that invest in venture capital do so through funds (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 2014b).

Others involved in the technology sector have called for the Australian Government to legislate to have superannuation funds allocate a small proportion of their funds under

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management to technology focused venture capital funds (*Australian Financial Review*, 23 February 2015).

### Poor returns have made venture capital a less than attractive investment

One factor affecting the attractiveness of the Australian venture capital sector is poor returns. Of 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 around 13 per cent over the same period (AMP 2013). 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 (AVCAL, pers. comm., 19 February 2015).

Not only are average returns on venture capital investments low, but the investments targeted by venture capital funds are inherently high risk with highly volatile returns (and occasional spectacular successes).<sup>21</sup> Institutional investors consider venture capital to be a highly speculative asset class (sub. 15). 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 (p. 2-65).

The Institute of Public Accountants (sub. 32) noted 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.

PwC (2013) also noted that venture capital funds were yet to generate sufficient returns 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)

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<sup>21</sup> This volatility is highlighted by the spread of investment returns. The standard deviation of the internal rate of return to venture capital funds investing in Australia and New Zealand between 1997 and 2014 was 172 per cent (information provided by AVCAL). In comparison, the standard deviation for returns to Australian shares based on the All Ordinaries Index between July 2005 and July 2015 was around 14 per cent (McGraw Hill Financial 2015).

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The venture capital industry in the United States has 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 percentage points 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 volatile and generally 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 businesses seeking venture capital 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 in a way that warrants the additional riskiness of the investment.

For some superannuation funds, higher risk and long term investments may be a part of their investment strategy. The requirements of the *Superannuation Industry (Supervision) Act 1993* require that trustees promote the financial interests of the beneficiaries or members of the funds. Funds that predominantly have younger members, for example, with a longer investment time frame until their retirement, may be more willing to take on greater risk and focus on longer term and illiquid assets compared to those with members closer to retirement who are likely to focus on less risky and more liquid assets.

Indeed, some venture capital funds have been successful in attracting investment from superannuation funds. For example, a Melbourne based venture capital fund recently raised \$200 million from four industry superannuation funds for its medical research commercialisation fund (BRW 2015). Also, a number of entrepreneurs and two superannuation funds recently committed to establish a \$200 million fund to target those start-ups that would have previously relocated overseas to seek funding (*Australian Financial Review*, 15 September 2015).

### Superannuation funds should not be directed to invest in particular asset classes

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 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).

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Any mandating of asset allocation by superannuation funds would distort capital flows, undermine performance and lower returns to retirees. Deloitte Access Economics (2013b) commented that:

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 also 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)

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.

#### 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.

## **Government measures to increase the supply of seed funding and early stage venture capital in Australia**

Government interventions to increase the supply of seed stage funding and early stage venture capital have been primarily through tax incentives and co-investment measures. These measures aim to address the 'funding gap' in the provision of capital to high-risk, start-ups (Cowling et al. 2008).

However, the existence of such a funding gap does not of itself indicate a failure of capital markets (not all businesses seeking funds necessarily merit them). The difficulties of some start-ups in accessing finance may reflect the high transaction costs investors face in ascertaining the growth prospects of, and in monitoring, small risky businesses. The OECD (Wilson 2015) also noted that while a funding gap was not necessarily a market failure, a number of governments have chosen to intervene for broader reasons, such as the potential role young innovative businesses play in economic growth and job creation.

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## The use of tax incentives

Targeted tax incentives are provided by a number of governments (including the Australian Government) to support venture capital investments in high-risk, start-ups.

The tax incentives provided to venture capital are either front-ended (tax credits or deductions for eligible investments) or back-ended (capital gains tax reductions or exemptions for eligible investments). The UK approaches of combining both front-end and back-end tax incentives do not appear to have been particularly successful in improving business outcomes (box 6.2).

The OECD notes that back-ended tax incentives through capital gains tax only reward successful investments or ‘winners’ and involve a lower fiscal cost for governments. Further, back-ended schemes based on capital gains tax incentives encourage risk taking rather than tax minimisation. Such incentives are generally provided either directly to individuals or corporations investing in eligible companies or to investments made by pooled investment vehicles, typically venture capital funds, into eligible companies. The OECD noted that there was some evidence that providing tax incentives directly to individuals may attract more business angels (OECD 2002).

These tax incentives generally have eligibility requirements around the type of businesses (often technology based), the stage of the business’s development (usually seed or early stage venture capital funding), the size of the business, the amount invested and minimum holding periods for the investment.

### *The tax incentive schemes used in Australia*

In Australia, the Review of Business Taxation (the Ralph Report) recommended targeted tax relief for venture capital investment to improve the working of Australia’s capital markets and encourage a greater level of innovation (Australian Government 1999). The current Australian schemes — the Venture Capital Limited Partnership (VCLP) and Early Stage Venture Capital Limited Partnership (ECVLP) — are all back-ended schemes using pooled investment vehicles. The broad objectives of these schemes are to:

- attract increased investment (particularly from overseas) into high-risk, start-up and expanding businesses that would otherwise have difficulty in attracting investment through normal commercial means
- develop Australia’s venture capital industry and the skills and experience in venture capital management.

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## Box 6.2 Investor tax incentive schemes in the United Kingdom

The United Kingdom provides investor tax incentives through the Enterprise Investment Scheme (EIS), the Seed Enterprise Investment Scheme (SEIS) and Venture Capital Trusts (VCTs). All these schemes provide front ended tax relief or tax deductions and capital gains tax exemptions for individual investors in eligible schemes.

The EIS provides a tax deduction of 30 per cent of the cost of the shares purchased in unlisted companies with total assets (including related companies) of less than £15 million and fewer than 250 employees. Any capital gains are able to be deferred. There are a number of excluded business activities including banking and finance, leasing, legal services, property development, farming and operating or managing hotels and nursing homes. Investors are capped at £100 000 in such investments in any one year to be eligible for the tax deductions and a company's raising are capped at £5 million per year. Eligible shares are required to be held for at least three years by the investor and investors are able to invest directly in a company or through an EIS fund. Those with a connection by employment to the company including partners and directors are ineligible for any tax incentives. There is an exception for directors who are 'Business Angels' where their connection with the company is as a non-remunerated director.

The SEIS is focused on early stage companies. It provides a tax deduction of 50 per cent for individuals investing in eligible companies (unlisted companies with assets less than £200 000 and fewer than 25 employees) on a maximum individual investment of £100 000 per year. The shares are required to be held for three years to be eligible for the tax deductions and the exemption from capital gains tax from the sale of the investment. The SEIS was originally set up as a temporary measure in 2012, but was announced as an ongoing scheme in the 2014 UK budget.

VCTs are designed to encourage individuals to invest in small unlisted companies through listed VCT funds. They are essentially a retail venture capital fund for private investors. VCTs are capped at investing up to £1 million per year in each eligible company (assets of up to £15 million and fewer than 250 employees) in their portfolio. Individual investors receive a 30 per cent tax deduction for their investment in a VCT, but are limited to a maximum investment of £200 000 per year. Investment in the VCTs are required to be held for a minimum of five years and there is a capital gains tax exemption on disposal of the shares and dividend income is exempt from income tax.

An independent evaluation of the impacts of the EIS and the VCT was undertaken in 2008 (Cowling et al. 2008). The evaluation compared the performance of EIS and VCT recipient companies to a matched control group of non-recipient companies over a nine year period. The evaluation found that investments made in companies under EIS and VCT, but particularly EIS, tended to be associated with an expansion in sales and employment, but with no increase in profitability. However, these quantitative improvements in company performance were very small. Survival rates for EIS and VCT supported companies were significantly lower than those recorded by unsupported companies.

*Source.* Department for Business Innovation and Skills (UK) and British Business Bank (2015); HM Revenue and Customs (2013)

The VCLP scheme was introduced in 2002. It enables new venture capital funds to raise funds to invest in Australian businesses with assets below \$250 million with at least half of their employees and assets located in Australia. These businesses must be unlisted and

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structured as a company or unit trust. Funds are not permitted to invest in businesses where the main activity is property development, banking and finance or construction. Foreign investors (or limited partners) are exempt from any capital gains made from eligible investments and any losses from the disposal of their investment cannot be off-set against other income or capital gains. The general partners (managers of the fund) are also eligible for tax reductions on the performance element of their remuneration. Since 2002, around \$2.8 billion has been invested by VCLPs, including \$251 million invested in 61 businesses in 2013-14 (Innovation Australia 2014).

The Tax Expenditure Statement (The Treasury 2015d) noted that the impact of exempting foreign investors utilising VCLPs from capital gains tax was not quantifiable, but estimated that its order of magnitude was in the range of \$10 to \$100 million per year. The tax benefits provided to the general partners or managers of VCLP funds were estimated to be in the range of \$0 to \$10 million per year.

The ESVCLP commenced in 2007. Its focus is on early stage businesses. Consequently, investment is limited to unlisted companies or unit trusts with assets below \$50 million and an ESVCLP is required to divest any holdings once the total assets of the investee business exceed \$250 million. Funds are required to have an appropriate investment plan focussing on venture capital approved by Innovation Australia. Similar to VCLPs, investments in businesses with property development, banking and finance or construction as their predominant activity are ineligible. However, both domestic and foreign investors are exempt from any capital gains made from eligible investments. Any losses incurred through an ESVCLP from the disposal of assets cannot be off-set against other income or capital gains for tax purposes. Since the ESVCLP commenced, around \$85 million has been invested in 74 businesses including \$37 million invested in 51 businesses in 2013-14 (Innovation Australia 2014). The Tax Expenditure Statement (The Treasury 2015d) noted that the impact of the tax exemptions provided to investors through EVCLPs was not quantifiable, but estimated that its order of magnitude was up to \$10 million per year.

#### *Are tax incentive schemes effective?*

These schemes were reviewed by Board of Taxation in 2011. The review found that given the life cycle of a venture capital investment was typically 7 to 15 years, it was too early to adequately assess the overall schemes' effectiveness (particularly the ESVCLP) at that time.

As to the appropriateness of the scheme, the Board found that the VCLP scheme extended too far as it allowed investments in the later stage private equity sector access to the special tax treatment intended to assist start-ups. Support for the later stage private equity sector went beyond what was typically necessary to address any market failure in terms of the venture capital sector (Board of Taxation 2011). Accordingly, the Board of Taxation (2011) suggested that the VCLP scheme be phased out by closing the scheme to new registrations and policy support be re-directed to support the early stages of venture capital activity.

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The Board considered that the ESVCLP scheme broadly had the right design features to facilitate investment into venture capital and develop skilled funds managers. Its more favourable tax treatment together with lower permitted entity value ensured that the investment was focused on early stage high risk venture capital. It also noted that capital gains tax relief for investment in venture capital tended to encourage risk taking rather than tax evasion (Board of Taxation 2011).

The Commission recognises the strengths of the existing ESVCLP in that it targets seed stage and early stage venture capital. It rewards success as the benefits of the capital gains tax exemption are only available when the investment provides a return. This also makes ESVCLP a less likely vehicle for tax minimisation. The ESVCLP also disregards any losses made by investors and the Commission agrees with the Board of Taxation that it is difficult to provide a rationale to have a scheme whereby ESVCLP investors could receive tax exempt gains and at the same time be entitled to deductions for losses.

Although individuals can invest in ESVCLPs, providing a capital gains tax exemption for direct investment by individuals in the same companies that are eligible for ESVLP investment may — as noted by the OECD (2002) — attract greater angel investment.

In considering the future of such arrangements, the Commission agrees with the Board of Taxation that any support for venture capital should be directed at early stage venture capital and new registrations for the VCLP be closed. The ESVCLP, with its focus on early stage businesses, is more appropriately targeted and should continue to accept new registrations. An independent evaluation of the impact of the ESVCLP on early stage business start-ups and its wider benefits against the loss in tax revenue should be undertaken in 2017 to take into account the commencement of these arrangements and the life cycle of venture capital. The evaluation should also consider the impact of providing tax incentives in the form of capital gains tax exemptions for direct investment by individuals in early stage venture capital. This evaluation should also include the existing VCLP funds.

If the Government intends to continue to provide tax incentives for venture capital investment, or continue with the ESVCLP, following this evaluation, any arrangement offering tax incentives should draw on the key features of the ESVCLP and be:

- back-ended to reward success and avoid tax minimisation
- limited to seed stage or early stage venture capital, where there are likely to be greater difficulties in accessing capital
- subject to an independent evaluation as to the overall costs and benefits after the scheme has been in place for an adequate period.



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#### RECOMMENDATION 6.4

The Australian Government's tax incentive scheme — the Venture Capital Limited Partnerships — to increase the supply of venture capital, should be closed to new registrations while the Early Stage Venture Capital Limited Partnership should continue.

Both the Early Stage Venture Capital Limited Partnership arrangements and the ongoing Venture Capital Limited Partnerships should be subject to an independent evaluation in 2017 as to the costs and benefits of these arrangements for the overall community. The evaluation should also consider extending the provision of capital gains tax exemptions for individual investors.

If the Government intends to continue to provide tax incentives for venture capital following this evaluation, future arrangements should be:

- back-ended to reward success and avoid tax minimisation
- limited to seed stage or early stage venture capital, where there are likely to be greater difficulties in accessing capital
- subject to an independent evaluation as to the overall costs and benefits after the scheme has been in place for an adequate period.

### The use of co-investment funds

Co-investment funds use government money to leverage private investment in start-ups through the establishment of early stage venture capital funds. Many of these schemes are based on matching public investment with private investment. The ratio of public to private investment varies across funds, with any returns going back to the private investor and the government. To increase leverage, some funds have allocated a higher return to the private investors and greater share of the losses to the government. Such funds have been used in the United States, the United Kingdom, New Zealand and Germany (sub. DR72). They also aim to develop and build the skills necessary to assess and manage early stage investment and increase the scale of the relevant seed stage funding and early stage venture capital market. Some of these funds are also used to promote regional development and address regional economic disadvantage. The OECD (Wilson 2015) notes that many of these programs in its member countries have not been formally evaluated and empirical analysis of the outcomes and impacts has been scarce due, in part, to challenges with seed and early stage funding data.

#### *The use of co-investment funds in some overseas countries*

The US Start-up America Initiative provides US\$2 billion through two US\$1 billion funds to match private sector investment in high growth potential businesses. The Impact Investment fund is targeted specifically at developing businesses in economically distressed areas and provides a 2:1 match to private capital raised by the funds. The Early

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Stage Innovation fund focusses on providing seed funding to early stage businesses with high growth potential without access to traditional funding. It matches private investment on a 1:1 basis. There is, however, some scepticism around the use of co-investment in the United States. For example, Cohan (2012) in regard to the US early stage innovation funds, Start-up America, said:

They create the illusion that private investors will be enticed by the opportunity for the government to provide capital next to their money to invest in the startup.

But the reality is that if these startups are good enough to attract any private capital, they are good enough to raise all their capital privately. And if they are not good enough to raise 100 percent of their capital privately, then a government match will not alter the private capital providers' decision-making process (p. 2).

The New Zealand Venture Investment Fund (NZVIF) was established in 2001 to accelerate the venture capital market in New Zealand to a point where it became self-sustaining. It encompasses initiatives to develop skills and experience and an investment fund to co-invest with the private sector in a series of privately managed funds. An evaluation of the fund in 2009 found that the NZVIF had a significant impact on the level of venture capital activity, although it was unclear as to the quality of the investments at that stage (Ministry of Economic Development New Zealand 2009). A survey of companies receiving NZVIF funds indicated that these companies had generally been successful in raising further capital. From the evaluation, the Ministry of Economic Development's view was that the future use of NZVIF funds should be reorientated towards early stage activity, particularly seed and start-up investment. The rationale for the NZVIF was strongest at the early stage as these companies were more likely to produce spillovers from research and development and investors were more likely to experience information asymmetries and higher transaction costs when investing in these companies.

#### *The use of co-investment funds in Australia*

The Australian Government's co-investment fund, the Investment Innovation Fund (IIF) was closed following the 2014 budget, with the Government declining to provide a fourth round of funding. The objectives of the IIF were to:

- encourage the development of small companies that are commercialising research and development by addressing capital constraints
- develop as self-sustaining, early stage venture capital industry in Australia
- develop funds managers with experience in the early stage venture capital industry
- establish, in the medium term, a revolving or self-funding program.

The fund closure followed on from The Report of the National Commission of Audit (Australian Government 2014e) that found the IIF provided specific assistance to the venture capital industry and, as with other industry specific assistance programs, recommended it be abolished to avoid distorting resource decisions across the economy.

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The IIF commenced in 1998 and provided 3 rounds of public funding up to June 2013. Its 16 licensed funds received a total of \$361 million from the Australian Government and \$283 million from private investors. In round 3, Government funding was required to be matched on a 1:1 basis with private sector funding whereas the earlier rounds had a lower ratio of private funding. Profits were returned on a 90:10 basis in favour of private investors. The total return to the Government from its investment in these 3 rounds was 42 cents for each dollar invested whereas for the private investors the return was \$1.13 for each dollar invested (Department of Industry 2013; The Treasury and Department of Industry, Innovation, Science, Research and Tertiary Education 2012). Not only did the fund design result in a poor return for Government, but it did not conform with the fund objectives of generating a self-sustaining venture capital industry and a self-funding program.

Australia's IIF program was subject to an econometric analysis by academics from the United Kingdom in 2010 (Murray, Cowling and Lieu 2010). The analysis focused on the outcome for those businesses funded by the IIF program in comparison to similar privately funded businesses. It found that the IIF had raised substantial finance for young and new knowledge-based businesses that would have otherwise been unavailable. Businesses that had received IIF funds were considerably more likely than other similar businesses to undergo an IPO (which can be an indication of either success or failure), but also considerably more likely to close through a liquidation. The funds made largely modest returns, which by itself would not attract long-term private investment in Australia's high technology entrepreneurs. It found that the objectives of the IIF were overly ambitious and that while the fund was important, it was unlikely to engender, on its own, a flourishing and viable venture capital industry in Australia.

This analysis highlighted that a viable early stage venture capital investment sector required not only a supply of risk capital, but also a large number of skilled and experienced entrepreneurs able and willing to utilise the available capital. The analysis noted that it was:

... unrealistic to expect a single government supported, supply-side VC programme to be anything other than one contributor to an entrepreneurial and innovation eco-system of considerable sophistication and complexity. (Murray, Cowling and Lieu 2010, p. 30)

AVCAL called for introduction of new \$500 million co-investment program building on the learnings of the IIF as a key component of Australia's innovation policy (sub. DR72). It contended that without government co-investment most of the venture capital investment in Australia over the past five years would not have occurred. Similarly, an Australian Government review of venture capital and entrepreneurial skills (The Treasury and Department of Industry, Innovation, Science, Research and Tertiary Education 2012) noted that while a causal relationship was difficult to establish, Australia's venture capital industry had developed while programs such as the IIF were in place and some of Australia's successful funds managers had attributed their existence to the provision of Government support.

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These claims appear somewhat questionable, given 2013-14 (the year following closure of IIF) was one of the largest years of venture capital investment in recent history. Further, the venture capital industry may well have developed equally well (or more robustly) in the absence of government programs such as the IIF.

At a state and territory level, the most recent co-investment fund is that established by the Queensland Government in 2015 — the Business Development Fund. This fund will provide \$40 million over four years to emerging and innovative Queensland based start-ups. These funds will be invested on a matching basis with private sector co-investors. The Queensland Investment Corporation will administer the fund and a panel will be established to assess proposals for co-investment. The opening of applications for funding will commence in late 2015 (Queensland Government 2015c).

### *Lessons for governments looking at co-investment funds*

From a policy perspective, there are a number of lessons from the limited evaluations of co-investment funds:

- These funds should focus on seed and early stage venture capital funding. There has been a tendency for co-investment funds to drift towards later stage investment as the investment decisions are easier and less risky due to the additional information available to evaluate the investment.
- Co-investment funds can provide a poor return on the use of government funds. This results when governments try to make the funds more attractive to investors by returning a higher proportion of the profits to private investors regardless of the investment ratios between the private investors and the government. The returns to both government and private investors should be commensurate to their investments in the fund to reduce distortions to investment behaviour.
- Careful design of the fund's arrangements are necessary. These include the responsibilities of the fund managers, the guidelines and criteria to apply for eligible investments, the ratio of public to private funding and the terms and conditions for the returns to the government and the private investors.
- Sound evaluation of the impacts of these funds is required to enable governments to assess their effectiveness in meeting objectives. Evaluation can also ensure that funds are concluded when their objectives have been met.

### **Other government initiatives to increase venture capital funds**

A further Government initiative to attempt to increase funding for the Australian venture capital industry is the recently announced changes to the rules of the Significant Investor Visa (SIV) program. From July 2015, SIV applicants will be required to invest \$5 million in complying investments including at least \$500 000 into venture capital or private equity funds(s) investing in start-up and small private companies (the Government expects to

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increase this to \$1 million for new applicants by 2017). A further \$1.5 million of the \$5 million is required to be invested into eligible managed fund(s) or listed investment companies that invest in emerging companies listed on the ASX (Robb and Cash 2015). These changes 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.

### Lessons for government involvement to increase the supply of venture capital

The Commission has concluded that there are no significant regulatory barriers to the establishment of new venture capital funds in Australia or to the flow of venture capital into Australia. There may be some issues with the small scale of Australian funds although a few larger venture capital funds, underpinned by investment from superannuation funds, have recently been established. The Commission does not consider that government intervention is required to further develop the Australian venture capital market.

The Commission also notes that venture capital (like other sources of finance) plays an important part in entrepreneurial ecosystems – the environment in which start-ups operate. The role of government with respect to entrepreneurial ecosystems is considered in chapter 10.

Nevertheless, for those Australian governments that currently have programs aimed at increasing the supply of seed and early stage venture capital and in developing these markets, there are a number of broad policy lessons that should frame any such involvement:

- Government involvement needs to be correctly targeted. Such involvement needs to focus on the stages of funding for start-ups where there are identified transactions costs that are so high as to prohibit capital market activity. Government programs tend to converge towards the same segment of the market as the private sector, rather than addressing gaps in the provision of risk capital (Lerner, Moore and Shepherd 2005). This can potentially crowd out private investors and delay the development of greater private participation.
- Any program to increase the pool of seed stage funding or venture capital is just one arm of policy. These programs focus on the supply side and the development of demand side policies — for example, human capital development through the use of incubators and accelerators to support development of businesses to the stage that they become worth investing in — are also important. A single policy intervention to increase the level of venture capital investment is not, on its own, sufficient to develop investible businesses. While increasing supplies of venture capital encourage innovation and entrepreneurial activity, high levels of these activities also stimulate the interest of venture capital.
- Government intervention in the venture capital market may impede private initiatives. Financial markets are continually evolving to solve problems around information

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asymmetry — the emergence of venture capital funds in itself was a response to the problem of how to provide capital to high-risk entrepreneurial activities.

- Evaluation should examine the additionality of the program. A key focus of the evaluation of such arrangements should be to determine how successful or otherwise they are in eliciting private investment that would not otherwise have been made at that time. This additionality should generate economy wide benefits that exceed the costs associated with the program.
- Governments should continue with the programs and tax arrangements that are able to generate economy wide benefits rather than making ongoing changes and adjustments. The duration of these programs, and their further evaluation, should reflect the time frame of the venture capital investment cycle.

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## 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 smaller banks, credit unions, building societies or superannuation funds undertaking more business lending than they currently do, however, generally there is not the appetite from these organisations to do so.
  - Interest rates for business loans from major 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.
  - Existing regulatory arrangements around peer-to-peer lending appear to be broadly effective given the industry's current small size.
- 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 banks adopt a relatively formulaic approach to lending and are less willing to lend on the basis of business prospects alone, but there are no impediments to lending on such bases other than the need to provide additional capital for prudential regulation purposes.
  - 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 that seek to drive economic activity in particular regions or industries should cease and programs with social objectives should be able to demonstrate clear and persistent net benefits in order to justify their continuation.

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## 7.1 The use of debt finance by new businesses

### Debt is an important source of external finance for businesses

Of the 16 per cent of businesses that sought external finance in 2012-13, over 90 per cent sought debt finance (ABS 2014h). As of March 2015, outstanding bank loans to business exceeded \$800 billion and in the March 2015 quarter, new bank lending to business was over \$80 billion (representing just under 10 per cent of total business lending by banks) (RBA 2015c). The amount of debt provided through domestic and off-shore bond issues is also substantial, with the value of bonds outstanding issued by Australian companies being estimated at \$233 billion 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, and has flow on effects for the Australian economy as a whole.

### Most debt used to start a business is personal debt

For nascent businesses, personal forms of credit, rather than credit in the name of the business itself, are important.<sup>22</sup> From the Comprehensive Australian Study of Entrepreneurial Emergence (CAUSEE), the most common sources of debt financing used by all 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, CAUSEE data indicates 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, see figure 5.5 in chapter 5).

The prevalence of new businesses founded with personal debt finance can be largely explained by the hesitance of lending institutions to provide formal business loans unless secured with collateral and predictable cash flows. For established businesses, this collateral may be sourced internally, such as through property, plant or equipment or inventory. New businesses, however, typically have neither sufficient 'in-house' assets to

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<sup>22</sup> The CAUSEE study defines a nascent business as 'firms in the processes of being created, but not yet established in the market'.



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secure a loan nor reliable cash flows to service a loan, and therefore, collateral is often sourced from the personal assets of the business founder — for example, a private home.

## **Formal business loans are only one type of debt**

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). Prepayments (also referred to as ‘reverse trade credit’) is also a source of finance for new businesses and arises when a customer pays in advance of a good or service being received.
- *Venture debt* — this is a specialised lending product that is designed for businesses still in their seed stage (that may have negative cash flows or little assets). However, it is typically only available to businesses that either already have strong financial backing (such as from a major venture capital firm) or that have a very large customer base. In effect, the venture capital investment is viewed as a signal about the business’s future prospects and in some cases, loans made by a bank may be implicitly guaranteed by the venture capital firm. The venture debt provider may also receive warrants that give the right to purchase equity at a future date at a fixed (and usually discounted) price (Jazdowski 2012; LeaderVentures nd).
- *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 issues 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 cost effective 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.
- *Debtor financing and factoring* — this involves a business selling its accounts receivable to a third party at a discount. The business selling its accounts benefits by

receiving money immediately rather than waiting for payment, while the purchaser makes a gain when the accounts are paid. Total debtor finance in Australia for the year ending March 2015 has been estimated at over \$60 billion (DIFA 2015).

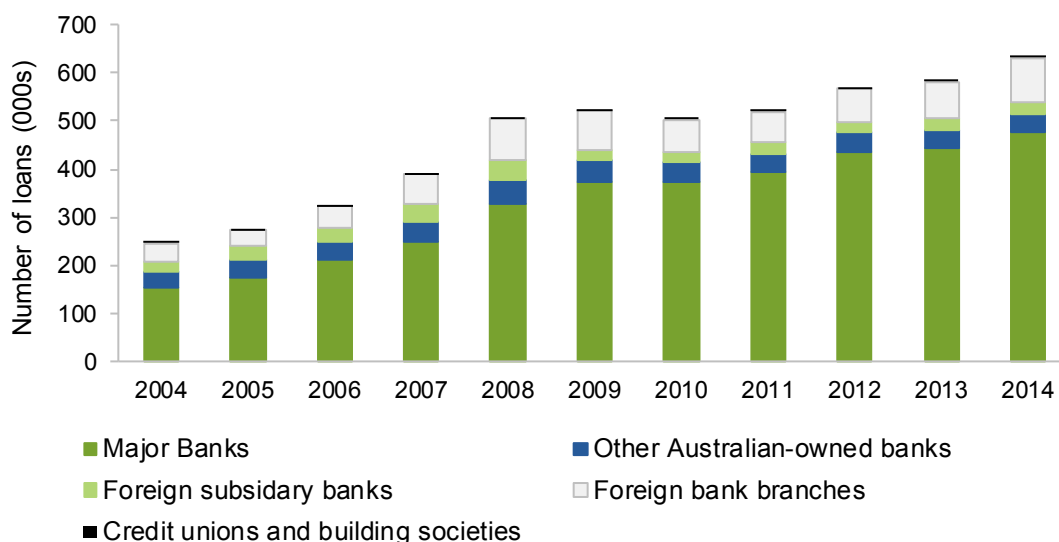
- *Family and friends* — CAUSEE data indicate that about 14 per cent of nascent businesses obtained debt finance from family or friends of the business owner (Davidsson, Gordon and Steffens 2012).
- *Leasing* — while not strictly a form of debt financing, leasing nevertheless has similarities and is often viewed as a substitute for debt. 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

### Banks dominate business lending ...

Almost all lending to businesses by authorised deposit-taking institutions (ADIs) 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 Total loans outstanding to businesses 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

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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 ADIs from providing debt to business should they consider such loans worthwhile. Rather, it appears that most credit unions and building societies do not have the 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 and administrative costs associated with direct lending to businesses.

There is some commonality in the relatively subdued interest in business lending by non-bank ADIs and superannuation funds — large-scale business lending requires a significant upfront investment in skills and resources, and an ongoing resource commitment to undertake due diligence. Further:

- 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 that are not secured by residential assets or mortgages. (APRA 2014; Gorajek and Turner 2010). 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

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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**

#### **Lending by consumer sales platforms**

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).

#### **Peer-to-peer lending**

Another emerging source of debt finance is peer-to-peer (P2P) lending. Currently, Australia's P2P market is relatively small — estimates suggest that P2P lending balances in Australia are less than \$25 million (Morgan Stanley 2015). However, the industry is tipped for considerable growth in the near future (Eyers 2015; Yeates 2014).

The emergence of P2P platforms in Australia follows the development of markets overseas, such as in the US and the UK (where loans originating from P2P lenders were around \$US12 billion and £UK1.3 billion in 2014 respectively). 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)

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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 models:

- *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<sup>23</sup>. 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.

Sources: 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:

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<sup>23</sup> 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).

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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)

As P2P lending is a relatively new innovation, it is difficult to project how widespread it will become. For example, there is uncertainty around how the traditional banking sector will respond to competition from P2P lenders, or the extent that P2P would be impacted by an economic downturn (where defaults on loans can be expected to rise). Nevertheless, there is an expectation that P2P lending will grow substantially in the near future. A recent report by Morgan Stanley estimated that P2P lending to consumers will exceed \$10 billion in 2020, while P2P lending to SMEs will exceed \$11 billion<sup>24</sup> (Morgan Stanley 2015).

In the draft report, the Commission was unable to identify any substantive barriers to the operation and growth of P2P lending in Australia, however, sought further views from stakeholders as to whether current P2P regulations were efficient and effective. No feedback was received, and the Commission considers this as further evidence that current regulatory arrangements are broadly effective.

As P2P becomes an established and more common source of credit for Australian SMEs, there may be calls for further regulation.

Any further regulation of P2P lending should be in response to demonstrable evidence of a problem or unacceptable risk, and have a clear rationale in terms of the intent, net benefits and effectiveness of any changes to regulations. Regulation that is implemented on the basis of unsubstantiated concerns from incumbent businesses or the public — rather than developing a case for regulation that objectively examines the nature and magnitude of risks — has the potential to lead to poor outcomes.

As Greg Medcraft — the Chairman of ASIC — noted recently:

The markets we regulate are built on the idea of risk taking — risk taking which supports wealth creation and economic growth. We see regulation as being about ensuring markets accurately and fairly price those risks and that market participants act with integrity ... Regulation should be careful not to stifle risk taking — or make it prohibitively expensive. (Medcraft 2015, p. 5)

It should also be remembered that P2P lenders are not banks. Unlike ADIs, P2P lenders do not qualify for deposit insurance and do not 'create money' as banks do. As such, regulating P2P lenders like banks is inappropriate. That said, it may be the case that the existing regulatory architecture is sufficiently flexible to accommodate a growing P2P

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<sup>24</sup> Morgan Stanley project 3 cases — a bull (the most optimistic), a base and a bear case (the least optimistic). Morgan Stanley uses its bull case for consumer lending and its base case for SME lending.

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lending market, or that examples of more effective regulation emerge in other more mature P2P markets overseas.

## **Collateral-based lending vs other lending models**

When a lender is deciding 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 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).

At the Commission's public hearing for this inquiry, the Australian Banking Association presented that when assessing loans, collateral was a peripheral consideration relative to other factors:

The key elements of the lending decision for a bank, in order of priority, place collateral - that is, security - right at the end of the list of five factors, I mentioned three of them before, the character of the capital and the capacity or cash flow of the business to perform, but at the end of the day that's what we're on about. We're in the business of wanting to finance businesses, viable businesses, and to make sure that the loan stands up and performs, the business succeeds and the bank, in the same way, succeeds because it has a successful customer. Collateral is there for when the wheels fall off. (ABA, trans., p. 105)

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## 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 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 'backstop' 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 as essential, particularly when making larger loans. These lenders 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, pp. 117–118)

## Views on the lending models of banks

Despite such arguments from lenders, the reality is that the vast majority of business loans are secured, and at least one of Australia's major banks has publically announced that it does not currently offer unsecured business loans beyond credit cards (Westpac nd). About three-quarters of small business lending is secured with collateral, with around one-half to 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.

Several participants put to the Commission that businesses find it difficult to obtain a loan if they are unable to provide collateral and that lenders were unwilling to make lending decisions based on the fundamentals of the applying business when collateral could not be provided (box 7.3).



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### 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 included in credit assessments. (p. 7)

The Australian Small Business Commissioner (sub. DR57) presented:

When applying for traditional debt finance, start-ups often struggle to demonstrate serviceability of a loan whilst they also lack business asset collateral. While such businesses may have a good business proposal, they can find it hard to substantiate this via a persuasive business plan. Lending institutions will also usually require financial history and/or cash flow projections in order to determine whether the start-up will be able to repay their debt. Due to the risk-averse nature of financial institutions, viable and profitable businesses can fail to obtain business finance from traditional commercial sources. (p. 3)

The Foundation for Young Australians (sub. DR56) commented:

For young entrepreneurs without significant asset holdings (including housing), obtaining commercial loans is difficult. (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)

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)

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, especially given the differing capital requirements of different loan types.

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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 potential upside to earnings may not warrant the additional cost and effort of establishing a relationship based approach to lending
- 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 (such as rigidity of processes, or a desire to produce standardised outcomes) 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.

### Falling home ownership will impact on loan collateral

An emerging issue 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 who own their own home has shrunk from 10 per cent to under 2 per cent, while the proportion who 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 or the replacement over time of debt by equity.

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:

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Young entrepreneurs may also be more reliant on their housing equity to access small business lending products since lenders are increasingly reluctant to rely on guarantees from family members. Lenders are less likely to accept third-party guarantees due to the rigorous due diligence expected by the courts. In addition, according to one lender, the tighter regulations under the National Consumer Credit Protection Act 2009 (NCCP) have made lenders more reluctant to rely on guarantees from family members when extending loans to first home buyers; this may delay homeownership for young entrepreneurs and reduce their capacity to build home equity. (p. 124)

That said, some major banks still advertise that a third-party guarantee may be a pathway for a business owner who cannot provide collateral to secure a business loan (Westpac nd).

### Business lending overseas

Anecdotally, the Commission has heard that it appears easier for new businesses in other developed countries to obtain debt 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 taxation and 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

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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)

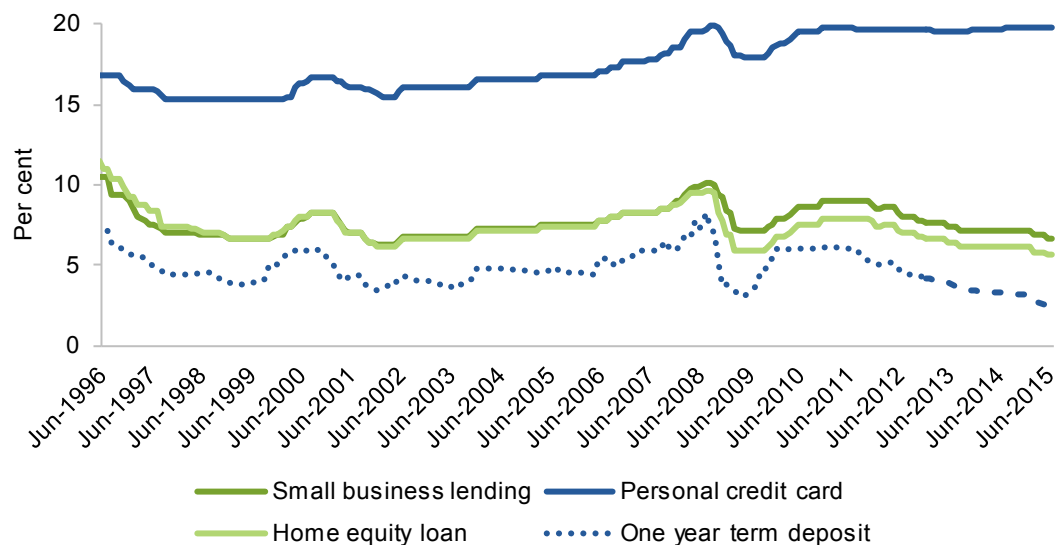
As part of their submission to the Parliamentary Joint Committee on Corporations and Financial Services Report into Access for Small and Medium Business to Finance, ACCI presented:

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. Indicator interest rates across a range of relevant lending products are shown below.

Figure 7.2 Indicator interest rates<sup>a</sup>



<sup>a</sup> 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, indicates that 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 26 August 2015

<i>Institution</i>	<i>Loan product</i>	<i>Interest rate (per annum)</i>
Commonwealth Bank of Australia	BetterBusiness Loan (secured by residential property)	5.90
	BetterBusiness Loan (secured by non-residential assets)	7.98
ANZ	Business Saver (residentially secured)	6.66
	Business Advantage (unsecured)	9.16
Westpac	Small Business loan (secured)	5.40
National Australia Bank	Business options(prime rate)	5.47

*Sources:* ANZ (2015); Commonwealth Bank of Australia (2015a); NAB (2015a); 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 a high cost alternative 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.

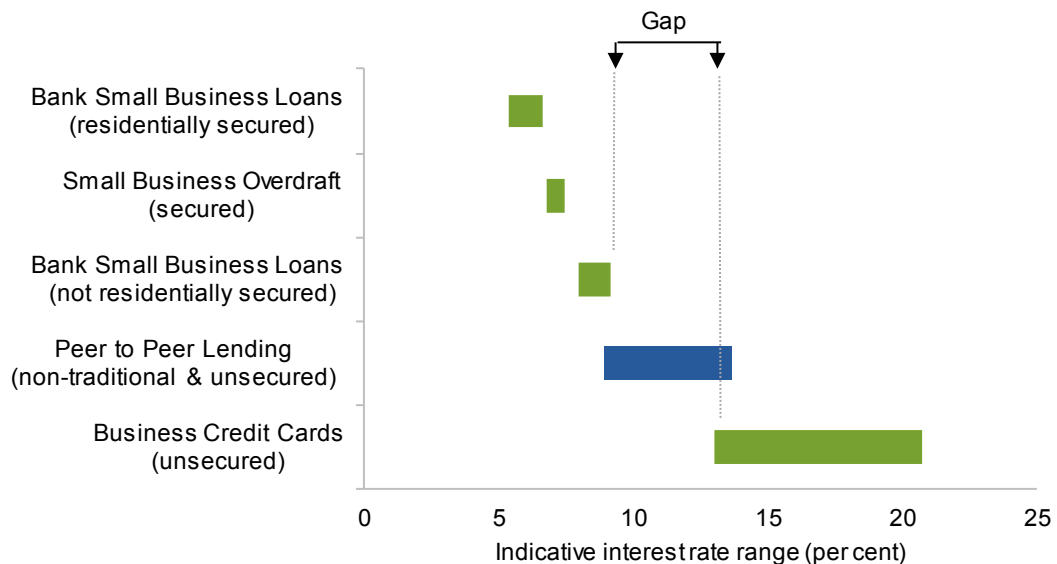
For some businesses that are being ushered onto credit cards, rather than a formal business loans, this may be because their business prospects, business plan or lack of collateral mean that a credit card is the most appropriate debt product. Other businesses may have business prospects conducive to a lower interest rate, but due to banks' inability or unwillingness to fully price on the basis of risk, are forced onto credit cards. The extent that this is happening — and this is not possible to quantify — 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<sup>a</sup>



<sup>a</sup> 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 (2015a); Mozo (2015); NAB (2015a); Westpac (2015)

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#### FINDING 7.1

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.

## 7.3 Options for improving access

### 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).

#### 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.

*Sources:* Johnson (2013); Office of the Australian Information Commissioner (2013)



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In short, these changes — if substantially adopted by the lending industry — mean that there will be more and broader 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
- 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 who 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 a loan.

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 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 as a means of reducing information imbalances between lenders and creditors and thereby improving credit availability for small businesses (sub. 8) and/or lowering the cost of borrowing for these businesses. 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 voluntary nature of CCR means that the long term participation in CCR remains unknown. This led the Financial System Inquiry to recommend that the Government should:

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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.

Given CCR is still relatively new in Australia, and there is uncertainty about the extent of its uptake, the Commission sees merit in a review in 2017 (after three years of operation) — 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.

### 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 introduction of CCR 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.

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#### 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 national scheme.<sup>25</sup>

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)

In their post-draft submission, the Chamber of Commerce and Industry Queensland also endorsed a role for government in underwriting businesses access to finance (sub. DR44). The issue of credit guarantee schemes has also received attention in a number of recent reports. For example, it has recently been advocated by Deloitte Access Economics (2013a):

Well-designed and managed [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. 30)

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<sup>25</sup> The South Australian Government does operate a limited (\$50m) CGS available to approved businesses in its jurisdiction, known as the *Unlocking Capital for Jobs Program* (Government of South Australia 2015)

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The Institute of Public Accountants also supported the introduction of a CGS in their *Australian Small Business White Paper* (2015):

To increase the availability of much-needed affordable loan finance to the small business sector, the Federal Government should introduce a state-backed loan guarantee scheme. The scheme would provide a limited State-backed guarantee to encourage banks and other commercial lenders to increase loan finance available to smaller and younger start-up firms that face difficulty financing new investment opportunities through normal commercial channels. (p. 27)

Those in favour of CGS argue that it would 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
- 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, although the cost to the community of achieving any such effects is not usually considered. Advocates also note that Australia is one of the few developed countries that does not operate a CGS.

Arguments against the introduction of a CGS include 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. In other words, a CGS can reduce a lender's loss in the event of default, but does not reduce the probability of default (and could actually increase it if banks are discouraged from undertaking adequate vetting and monitoring).
- There is little conclusive evidence that a CGS results in more business loans being made (box 7.5). In other words, there is not clear additionality or incrementality from introducing a CGS.
- The costs of setting up and maintaining a CGS 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.

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## Box 7.5 Studies on credit guarantee schemes

The effectiveness or otherwise 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 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 facilitates lending to SMEs that would not otherwise qualify for loans, 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, Green (2003) and O'Bryan III (2010) concluded that it is difficult to prove that CGS do contribute to additional lending to small businesses while De Rugy (2007) suggested that the rate of business start-ups in the US would be the same both under and without the 7(a) CGS in the US.

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 take part.

Studies have also examined whether CGS distorts the credit market — for example, Cowan, Drexler and Alvaro (2012) find that CGS reduces the effort exerted by banks in collecting loans, which has marked effects on the proportion of loans 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)

Setting the optimal price of a CGS 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 2013d). A further complication is the

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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 Commission examined public guarantee schemes in 2014 as part of its inquiry into public infrastructure and noted 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 (PC 2014a).

In relation to its current inquiry, the lack of systemic financing problems for new businesses substantially weakens the case that Australia needs a CGS. Furthermore, as discussed above, CGS are distortive and inefficient, they transfer risk from private parties to taxpayers, and may adversely affect the vetting and monitoring behaviour of lenders. Whether CGS materially increase either the amount of loans for new businesses (that is, delivers additionality) or business survival rates is also disputed in a number of studies. For these reasons, the Commission recommends that CGS not be pursued by Australian governments.

#### RECOMMENDATION 7.2

Australian governments should not pursue credit guarantee schemes as a means of enhancing the ability of new businesses to access debt finance.

### **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 7.6.

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### Box 7.6 Examples of concessional lending in Australia

- **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 26 August 2015, these interest rates ranged from 3.23 to 3.45 per cent per annum. Applications are assessed against an eligibility criteria that includes an assessment of the viability prospects of the business. The program operates as one part of a wider government assistance program to primary producers called the **Primary Industry Productivity Enhancement Scheme (PIPES)**.
- The **Business Development and Assistance Program** is an **Australian Government** program that provides loans at a discounted interest rate 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.
- In the 2015 budget, the **Australian Government** announced a concessional loan program for the construction of port, water and electricity infrastructure in Northern Australia. The program, which has a total value of \$5 billion, will be made available to both private organisations and state and territory governments.

*Source:* ACT Microcredit Program (2015); Government of South Australia (2014); Hockey (2015b); Indigenous Business Australia (2015); Queensland Government (2015b); Saulwick (2015); Tasmanian Government (2013)

As the OECD identifies, government intervention in the credit market to promote the formation of new businesses carries considerable risk of generating deadweight losses and displacement effects to the detriment of the wider community. According to the OECD, deadweight costs require consideration of:

the extent to which participants would have set up a new business without the subsidy. Since behaviour of these ‘deadweight participants’ is unaffected by the scheme, their participation does not contribute to economic value but involves a public outlay. The social cost of this outlay is the sum of the distortionary cost or excess burden of the tax that finances it and the expenses to cover arrangement costs.

While displacement effects refer to:

the extent to which subsidised businesses take business from and displace employment in existing, unsubsidised business. (Organisation for Economic Co-operation and Development and EC 2014, p. 94)

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As noted in the Commission’s Inquiry into public infrastructure (PC 2014d), an additional risk with concessional loan programs is that they may ‘ensnare’ governments, who having invested in an underperforming program or project, may struggle to withdraw, even if it is in the community’s best interest:

[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)

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)

Further illustrating this, the Queensland Competition Authority recently examined the Queensland’s Government’s Primary Industry Enhancement Scheme (PIPES), which includes First Start Loans, noting that it was unlikely the program delivered benefits to the wider community. The review recommended the program be abolished (box 7.7).

#### **Box 7.7 Queensland Competition Authority’s findings on PIPES**

In July 2015, the Queensland Competition Authority released a review into Industry Assistance in Queensland that included an examination of the Primary Industry Productivity Enhancement Scheme (PIPES). The Review questioned the underlying rationale of the scheme:

... there is no evidence that Queensland primary producers have sufficiently unique characteristics that would justify access to subsidised financial capital over any other Queensland business.

And continued on to note:

Given that applicants for PIPES must demonstrate sound prospects for commercial viability and the ability to service the loan long term, it is likely that some producers would have obtained a loan at market rates in the absence of the program. Therefore, it is highly probable that most of the benefits of this program entirely accrue to the producers receiving the assistance and the cost is borne by the taxpayer.

As a consequence, the Review recommended that the PIPES be abolished.

Source: Queensland Competition Authority (2015, pp. 80, 83)

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



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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 unemployed, 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.

Several OECD economies either operate, or partially fund, microfinance programs designed to assist unemployed or other socially or economically disadvantaged persons to start or buy a business (Leone and Porretta 2014; OECD 2013b, 2014c). Reviews of the French microcredit programs suggest such programs can provide a path to self-employment for unemployed persons with the survival rates of supported businesses similar to the broader business population (Balkenhol et al. 2013; Kuhle 2006). This suggests that there is the potential for such programs to be effective, however, governments need to be disciplined in their approach.

There are a number of criteria governments should apply if developing policies that centre on providing concessional loans for new business owners:

- For concessional loan programs that provide regional or sectorial assistance, the case for government intervention in the credit market is weak. There is not a clear market failure that government interventions seek to redress, and the risks that interventions will result in deadweight costs or displacement effects are high, to the detriment of the wider community.
- Concessional loan programs that seek to address social disadvantage may be effective if they facilitate a movement from welfare to financial self-sufficiency. That said, these programs should be underpinned by principles of good policy design, namely:
  - The objectives of the program should be well-defined. If the purpose of the program is to address disadvantage, then this should be explicit. Having clear objectives not only helps to ensure the program is targeted but 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. The ambit of the program should be limited to addressing this market failure. Intervention in the credit market in the absence of a market failure will impose unnecessary costs on the wider community, and/or crowd out private investment providers.
  - Businesses that are supported under these programs should be viable over the medium- and long-term without government support. In effect, concessional

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lending should only support propositions that are denied finance because of a market failure, but otherwise would be a viable business.

- Programs should be regularly evaluated to ensure that they are delivering net benefits to the community. These reviews should be independent, evidence based and be publicly available. Programs that fail to deliver clear and persistent net benefits should cease.
- While concessional loans can help disadvantaged subsets of the population access finance in the presence of market failures, this should be supplemented with other forms of support, such as mentoring, training and network opportunities to maximise the likelihood of a supported business succeeding.

The Commission considers there are very few cases in which these criteria would be satisfied and therefore it would be rare that a government loan scheme would be beneficial to implement, from a community-wide perspective.

#### RECOMMENDATION 7.3

Governments should cease programs that offer concessional loans to new businesses on the basis of their location or industry.

For concessional loan programs provided to new businesses as a means of addressing social disadvantage, clear and persistent economy-wide net social and economic benefits should be able to be demonstrated. In the absence of these benefits, these programs should also cease.

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## 8 New business models, the digital economy and regulation

### Key points

- With lifestyle and demographic changes and rising incomes, consumers are increasingly seeking new and innovative products and services or improved delivery methods — particularly when it enhances convenience. Consumers have embraced the Internet and technological innovations 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 businesses, innovation and new technologies provide a source of high growth in income and value for those able to bring new models and approaches to market. 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 individuals and households.
- Most new business models fit within existing regulatory requirements. For those 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 most loudly by incumbent businesses or their representatives.
- Governments and regulators have a number of tools available to proportionately manage the potential risks of new innovative business models to the community while not unnecessarily hindering those that offer products or services that benefit the wider economy.
  - Regulators need to maintain a flexible approach to enforcement. All jurisdictions should provide a framework for granting fixed-term regulatory exemptions limited to those regulatory requirements that inhibit entry or new business growth. Regulators should have the capacity to place conditions on the regulatory exemptions to protect consumers, public health and safety, and environmental outcomes.
  - Governments should have rolling reviews of regulation to assess whether the objectives and design remain effective in light of new business models and technology. 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 tools available to government to capture the broader benefits of these new businesses while managing any risks to society.

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## 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, the nature of its product or service offering, customer profile, marketing and advertising approach, distribution channels, revenue sources and organisational structure.

New business models look for innovative ways to create value and generate profits. Recent innovations are making rapid changes in the way businesses operate (or need to operate in order to survive).

- Online retail sales of goods and services represent a substantial part of the retail market with sales estimated to be \$17.3 billion in the 12 months to June 2015. This level is equivalent to 7.1 per cent of spending at ‘bricks and mortar’ stores (NAB 2015b).
- With the rising of online book sales and the introduction of electronic books in competition with printed books, revenue from physical book stores declined by 8.3 per cent per year over the 5 years to 2014-15 (Books and Publishing 2015).
- The move from general advertising in print media to personalised online advertising based on customer information gathered from previous sales or past Internet searches has had a profound impact on advertising methods. Internet advertising, which accounted for a small proportion of media advertising in 2000, is estimated to represent almost half of all media advertising by 2020. In comparison, print media is predicted to fall from 50 per cent of media advertising to around 15 per cent in 2020 (Ruthven 2015).

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. At times, this causes uncertainty and unease among industry competitors and the broader community, particularly when changes are large and enable further, rapid business model evolution.

This current 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. However, the distinguishing feature of this wave of transformative business models is that the superior collection, analysis and application of information has enabled new and better ways of doing business. 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 optimise the availability of bikes at its stations (Lee Yohn 2015).

A sharing or peer-to-peer business is one new model embracing information technology that has challenged and changed the way business is undertaken (box 8.1). The central

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## Box 8.1 **Businesses in the peer to peer and sharing economy**

### **Peer-to-peer platforms — connecting buyers and sellers of services**

#### *Freelancer*

Freelancer is an online professional outsourcing market place connecting employers with skilled workers. Businesses post projects on the platform — in areas such as software development, data entry, engineering, marketing, accounting and legal services — and freelancers bid to undertake work. Projects are often low value with the average project completed for US\$200. Freelancer's business model challenges the traditional method of outsourcing as it taps into a global market where businesses seeking professional services are not restricted to the skills in the local area.

#### *99designs*

99designs is an online graphic design marketplace, sourcing business design options (such as logos and websites) through a 'design contest'. Designers from around the world compete for the design work by submitting designs. 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 completed 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.

### **Sharing of assets — collaborative consumption of assets**

#### *Uber ridesharing*

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 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 in the car. 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*

Airbnb is a website that connects people with accommodation to let with people seeking somewhere to stay. Airbnb facilitates the connections but does not itself own any accommodation. This model differs from traditional accommodation where the business has purpose built premises, such as motels. It is similar, in some instances, to coastal 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 a part, or at times all, of their primary residence.

*Source:* Freelancer (2015); Lacy (2012); Uber (2014b); Lott (2014)

element of this 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 service rather than directly producing or supplying goods or services. This type of new business model is based on access to, rather than ownership of, assets (both physical and skills) and often low cost,

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high frequency trades. In the past, high transaction costs associated with identifying potential buyers and sellers meant that such trades were not worthwhile. 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. Collectively these businesses form the sharing economy — also known as the peer-to-peer economy or collaborative consumption economy.

While the emergence and challenging impact of new business models is not unprecedented, the pace and magnitude of transformation associated with the current wave of new business models (largely based on digital technology) have been substantial, and are often referred to as ‘disruptive’. Disruptive business models are not merely the digitisation of an existing business. Rather, they challenge and change 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 means to make calls into to a small computer with numerous communication tools, among other functions (Capgemini 2015).

### **For business, there are winners and losers**

Digital 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 to compete with established businesses. 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 in a relatively short space of time. Existing businesses often need to:

- adapt (such as a department store offering a variety of channels for customers to research and shop — ‘bricks and mortar’ and online stores — to provide a seamless shopping experience)
- restructure, including by moving out of a line of business in some markets (for example, as part of Kodak’s 2012 business model restructure, it ceased making digital cameras (Kain 2012))
- cease operating (such as the decline in physical video and 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).

### **But there is better 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. Many of these assets lay idle for considerable periods of time. For example, the

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Grattan Institute (2015) estimated 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 one and a half weeks per year.

The benefits of better utilisation of assets have the potential to be significant as they are 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. 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). 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 more efficient allocation and use of goods (Olma 2014).

### **Greater choice and access to products and services**

Innovative new business models also offer benefits to consumers. The increased competition provides greater access to, and choice of, products and services. This can come at lower prices, however consumers may be willing to pay more for better quality products and services or more convenient access.

It may also enable a larger range of customers (of different geographical areas and income levels) to consume 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) found three different sources of sharing economy benefits for below-median income families:

- *Greater access*: below-median income families are more likely than above-median income families to participate in the sharing economy indicating greater access to assets through peer-to-peer marketplaces than otherwise.
- *Opportunity to save on asset ownership costs*: below-median income families are twice as likely to forego asset ownership, driven in part by the ability to avoid the fixed costs of ownership when a peer-to-peer rental marketplace is an option.
- *Facilitating ownership*: a significantly higher proportion of below-median income consumers choose to purchase new assets to participate and earn an income in the peer-to-peer market place.

In addition, there is anecdotal evidence that some ‘asset rich and income poor’ households are earning extra income through those Internet platforms that create an economic market for spare capacity. The additional income received can assist people financially, for example, when they have lost their job or following a marital breakdown. 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).

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## 8.2 Regulatory challenges of digital business models

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 the regulation was drafted.

It is often in those sectors that have historically resisted competition reform (where existing caps, licence or regulatory requirements act as a barrier to competition) and/or have high economic rents where new business models are most attracted and face the most significant regulatory barriers to set up and growth. These regulatory barriers to new business models or the use of disruptive technology are not new or restricted to the sharing economy (boxes 8.2 and 8.3).

### 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, curries, gourmet hot dogs, desserts and barista coffee). Food trucks move around to different city locations 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.

Some local councils have placed restrictions on these trucks. 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 truck proprietors argue they are unfairly restricted when the council is failing to provide sufficient infrastructure, such as bins, or not emptying bins regularly.

#### Zero-waste café

A zero-waste café in Melbourne — serving soup that used by-products of restaurants such as unused meat and seafood bones — encountered regulatory difficulties with the location of its compost machine in an adjacent laneway where wheelie bins were kept. As a condition of the planning permit, the council required the café to accept liability for the compost machine as a permanent structure in the laneway, and pay a fee of \$12 500. The café owner refused to pay the fee, claiming that there were community benefits from the operation of a zero-waste business, including elimination of the need for rubbish collection from the café. The business closed in March 2015.

*Source:* Wu (2014); Worrall (2015)



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**Box 8.3      Regulatory consideration in the use of disruptive technologies****Remotely piloted aircraft**

Remotely piloted aircraft (RPAs) range from small devices weighing less than a kilogram flying for short periods of time at low altitudes to fixed wing aircraft of hundreds of kilograms operating at over 5000 metres. RPAs often have cameras installed that can record or stream footage to a mobile device. RPAs are used in a broad range of fields including law enforcement and emergency services (search and rescue); mining and agricultural applications (accessing remote areas to survey); real estate aerial photography; and inspection of electricity infrastructure, as well as use by interest groups and recreational users. The use of RPAs raise a number of safety, privacy and environmental issues. In terms of safety, RPAs have been regulated since 2000, but with the technology and application still rapidly emerging, safety regulations are currently under review. A 2014 House of Representative inquiry reported that it was unclear if existing privacy and surveillance laws are adequate.

**3D printing**

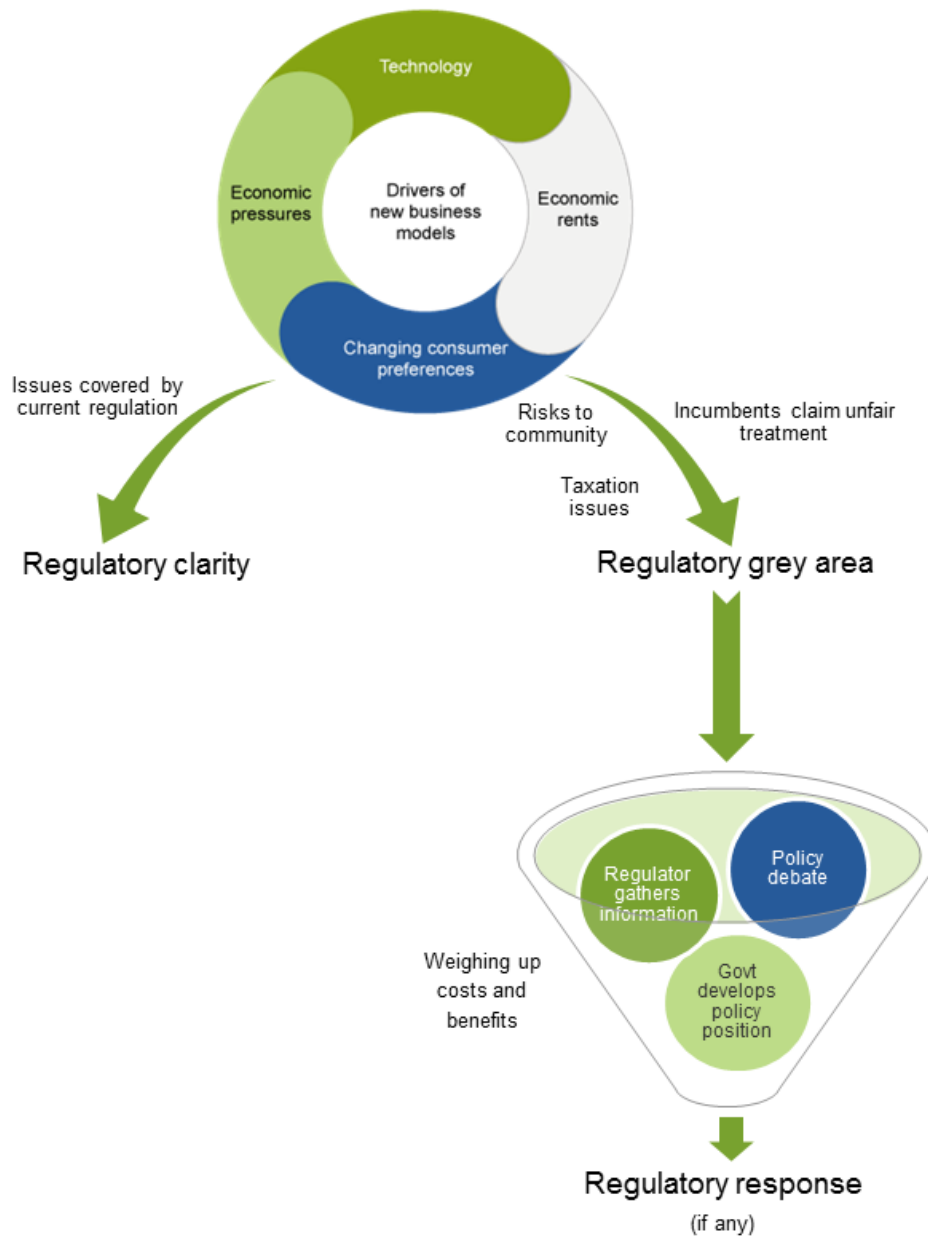
Three dimensional (3D) printing, or additive manufacturing, uses one of a number of potential processes where successive layers of material (such as plastic or metal) are laid down under computer control. The main advantage of 3D printing is the ability to produce prototypes and to customise goods at a considerably lower cost than traditional methods (through the use of less raw materials and more a streamlined computer driven process for design changes). While 3D printing is largely still the domain of industry, albeit a vast variety of industries, it has the potential to raise a number of regulatory concerns including intellectual property issues, ethical issues (in relation to medical applications) as well as the ability to use 3D printing processes to manufacture undesirable objects (such as weapons).

*Source:* Magrina (2014); The Parliament of the Commonwealth of Australia (2014)

Governments and regulators face ongoing challenges in applying existing regulatory frameworks to new business models with differentiated products and services in a rapidly changing environment. Activities and behaviours of new business models can present real and complex regulatory issues, but governments and regulators should not act in a ‘knee-jerk’ fashion to tightly regulate or prescriptively enforce existing regulations. Such action could lead to poor regulatory outcomes that stifle innovation and limit the possible benefits from these new business models.

Governments and regulators should consider instead the costs and benefits of the new business activity on a case by case basis, evaluating whether there have been developments in the market that mitigate some potential risks (figure 8.1). There will, however, be times when governments need to review the regulatory environment and develop a new framework to ensure a holistic approach — when risks cannot be moderated in other ways. For example, the Australian government is developing a regulatory framework for crowd-sourced equity to ensure investors are protected (chapter 6).

Figure 8.1 **New business models and regulatory pressures**



## 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 8.4). For example, critics of the mobile-app based ridesharing platform, Uber — that links customer’s demand for transport with

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available drivers for a fee — claim its business model falls outside industry specific taxi regulatory requirements as it does not provide taxi services. Uber notes 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 8.4 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 be determined from consumer observations and the consequences of eating unsafe food can be severe.

*Source:* PC (2008b)

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 prohibiting to accommodating (box 8.5).

However, there are several mitigating factors that may mean the lack of industry specific consumer protection is not as much of a concern or does not pose such large risks to consumer groups as on 'first glance'.

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## Box 8.5 Regulatory responses to ridesharing

### Australia

As at August 2015, Uber ridesharing was operating in Adelaide, Brisbane, Gold Coast, Melbourne, Geelong, Perth and Sydney. Some state governments have indicated that ridesharing services offered by Uber contravene passenger transport regulations. Since late 2014, Uber has agreed to comply with driver accreditation laws in Victoria. A number of regulators in various jurisdictions have issued cease and desist notices and/or issued fines to ridesharing drivers. However, during 2015, New South Wales, Victoria, Western Australia, South Australia, Northern Territory and ACT governments announced reviews of the taxi industry regulation following the introduction of ridesharing in Australia.

### New Zealand

Uber ridesharing began operating in Auckland and Wellington in 2014. With entry into the passenger service market largely deregulated, Uber ridesharing drivers work as a private hire car service fulfilling the necessary regulatory requirements. However, police have issued drivers with infringement notices (which were later withdrawn) for using their smartphone app as a meter to calculate the fare. The use of a meter is prohibited for private hire cars as fares are determined at the time of booking. Uber's smartphone app provides a fare estimate range (for example \$25-\$27). As the issue has not been tested in the courts, it is unclear, under New Zealand regulations, whether a range is sufficient to consider the pricing being preset and whether the smart phone app is a pseudo meter.

### Europe

In England, Uber ridesharing is operating under regulation as a minicab service. However, as in New Zealand, incumbent black cab drivers have argued that the app breaches laws preventing minicab drivers from using taximeters. While the regulator has received advice that the Uber app is legal (ie. not a taxi meter), it has sought a ruling, in 2014, from the High Court to clarify the issue.

In Continental Europe, the legality of Uber's ridesharing service has been tested in the courts — with services banned by courts in the Netherlands (December 2014), Madrid (December 2014), Germany (March 2015), Brussels (April 2015) Italy (May 2015) and Portugal (June 2015). In July 2015, a Barcelona judge referred a series of questions to the EU's highest court for decision. In Brussels, the local government announced (May 2015) that it is redrafting taxi regulations to accommodate ridesharing services within a new framework, including requiring ridesharing drivers to meet the same professional requirements as taxi drivers.

### United States of America

In the United States, 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 required to have background checks and cars undergoing inspections. In doing so, regulators have debated the merits of which party should hold licences (the platform or drivers), whether there should be caps on the number of licences in total or per company and whether pricing controls should be introduced.

*Source:* Uber (2014c); Taxi Services Commission (2015); Lomas (2014); Steitz (2015); Dastgheib and Hill (2015); Portugalpress (2015) Fairless (2015); Brinded (2015); Agence France-Presse (2015)

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First, digital intermediary businesses generally have design features that reduce information asymmetries between the service provider and customer. This provides some consumer safeguards and decreases the inherent associated risks that regulations are 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 can access 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 traditional businesses.

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. Businesses have internal policies and standards to underpin their product or service and their market reputation and many also face industry standards. Uber, for example, requires drivers to be at least 21 years old with a full drivers licence, have completed 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. Nor will the rating system always 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 prices that vary with the time of day or year, or with characteristics of the customer. This has led to criticisms of price gouging and

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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 8.6).

Under this pricing strategy some consumers have been ‘caught out’ with high fares at peak times — not realising the cost of the service used 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.

### **Box 8.6      What is dynamic pricing?**

Dynamic pricing is a strategy that allows businesses to vary prices according to the level of demand (which differs depending on the time of day or day of the week, for example), the cost of supply and the availability of supply (including the number of other suppliers and prices charged). 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 provides the 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 ticket 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 ridesharing (known as surge pricing).

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 operate at peak times. Demand surges are also monitored by Uber, who have on occasions used their discretion to lower prices.

*Source:* Kedmey (2015)

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 of a product or service that they have purchased are not reasons to introduce price controls. Indeed, introducing price controls in a market that is otherwise competitive would lower the efficiency of the market and reduce the number of market participants or services provided.

Instead, market-driven information provision can lead to better outcomes. Businesses, both new and incumbent, should inform consumers of the price prior to provision of the product or service. For example, consumers are informed of surge pricing practices used by Uber as a condition of use and are notified, on requesting a driver, when higher price periods apply. Uber also undertook an information campaign prior to New Year’s eve to let

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customers know that prices were expected to be higher during certain times and providing suggested ways to avoid the peak pricing (Singhal 2015).

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). Despite such actions, 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. Apart from the inefficient nature of these price controls and the cost of enforcing such arrangements, they are likely to be unnecessary. Damage to the business's reputation from exploitation of pricing power would usually result in consumers choosing competitors in the future — thus preventing prices from increasing excessively at unannounced 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 and safety**

### **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 in 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 property users
- increased risk to public safety
- inappropriate disposal of rubbish
- traffic and parking congestion
- loss of sense of community and connectedness (Legislative Council (NSW) 2014).

The regulatory arrangements of short-term rental accommodation are established and implemented by local governments and, consequently, are varied and mixed. A 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 period, 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 an example of outcome based regulation, permits holiday lets without its consent provided that:

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... 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 of sites other than registered accommodation businesses. Property owners renting out rooms or houses or apartments on a short-term basis have been issued with warning notices of possible fines by local governments. It has been reported that Randwick City Council, for example, issued warnings of potential \$1 million fines — the penalty for a breach of the local planning controls for an unauthorised bed and breakfast (McKenny 2014).

A number of state and territory governments are examining these regulatory issues. In Victoria, a panel appointed to review the issues associated with the impact of short-term rental in city apartment buildings had difficulty formulating recommendations that met all the criteria of the terms of reference nor could the panel come to a consensus view on the recommendations. The panel highlighted that most of the options considered were not appropriate ‘because they are too broad, too heavy handed, unworkable, inapplicable to existing building or insufficiently enforceable’ (Consumer Affairs Victoria 2015a, p. 35). 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 existing registered accommodation businesses for the state government 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 potential 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 (or more effectively enforcing existing regulations) 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 recognises that planning, zoning and development assessment laws and processes are complex with many (sometimes competing) objectives. However, as outlined in chapter 3, planning, zoning and development regulatory processes can represent a major barrier to, and impose significant time and monetary costs on, new business set ups. There



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is also 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 2011a, 2014e). This reform should be a priority for state, territory and local governments (chapter 3 and section 8.3).

### **Inconsistent treatment of incumbents and new entrants**

Regulation aims to provide net benefits to the community through requiring businesses to undertake certain actions that they may not otherwise undertake (chapter 3 outlines regulatory requirements of starting and operating a business). These regulatory obligations can 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 compliance (box 8.7).

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 incumbent businesses. For example, some properties available to rent on websites such as Airbnb are domestic dwellings 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 current regulatory requirements for existing businesses in order to achieve the desired net benefits 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 a greater level of competition that would benefit consumers and the broader economy.

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## Box 8.7      **Claims of inconsistent regulatory treatment**

### **Short-term accommodation industry**

The Accommodation Association of Australia has criticised Internet platforms used for short-stay tourism accommodation of 'flagrant disregard for numerous regulatory requirements' and of 'severely compromising the safety of guests' (sub. 25, p. 1). 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.

### **Parking**

Residents are increasingly renting out their driveways, apartment block parking spaces and on-selling street parking through peer to peer Internet platforms (such as Parkinghound). These practices are more common in inner city areas where residents are less likely to own a car (and therefore not using an allocated parking space) and work commuters are seeking ways to minimise parking and transport costs.

City of Perth Council requires registered parking providers within the Perth Parking Management Area to have planning permission, to be licensed and pay annual fees around \$1000 per parking bay. The Council has noted that operators not complying with these requirements were unfairly advantaged.

### **Sex work industry**

The adult services industry has complained about some online dating services that blur the lines between traditional dating and prostitution and escort services. These Internet websites match predominately older financially established men ('sugar daddies') with young women ('sugar babies') — with men paying to spend time with the women and buying them gifts under the guise of 'companionship'. Although less common, there are also websites that match older financially established women ('sugar mummies') with younger men under similar arrangements. It has been alleged that this type of arrangement amounts to prostitution and therefore falls under the legislation that exists to deal with sex workers. The laws regarding prostitution vary from state to state, but brothels (where legal) are required to be a licensed business with an approved manager, have strict controls on advertising, signage requirements, occupational health and safety obligations and requirements to monitor workers' health status. However, Australian prostitution laws predate the Internet, leaving some dating websites in a grey area. The Australian Adult Entertainment Industry spokesman William Albon claims the current regulatory arrangement is not a fair and level playing field.

*Source:* WA Department of Transport (2015); Sansom (2014); Consumer Affairs Victoria (2015b); McGhee (2015); Nedim (2015)

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## **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:

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- the possible lack of collection of GST by suppliers in the sharing economy
  - the exemption of GST collection on low value imports (generated from online sales)
  - potentially undeclared income of individuals renting underutilised assets, such as cars or spare bedrooms, or supplying their labour.

## GST and the digital economy

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 8.8).

As some suppliers in the sharing economy will have sales below the GST collection threshold, they will not need to charge and collect GST. However, in the advice provided, the Australia Taxation Office have broadly defined ‘taxi’ (for GST purposes) to include ridesharing or ‘ride-sourcing’ services, requiring these drivers to register for GST regardless of their turnover — as do those drivers who are non-employees in taxi and hire car businesses (Australian Taxation Office 2015c). Uber has challenged this advice in Federal Court of Australia. A decision is not expected before the end of the 2015.

### **Box 8.8 Registration for GST and exemptions**

As outlined in chapter 3, most businesses are required to 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.

In an attempt to capture previously forgone tax revenue, the Australian government announced — in the 2015-16 budget — that GST would be extended to cross border supplies of digital products and services imported by consumers from 1 July 2017.

*Source:* PC (2011c); Australian Taxation Office (2015b); Australian Government (2015a)

In the absence of overall regulatory reform (including regulated pricing) in the taxi industry — and given the constitutional requirement for Commonwealth tax laws to apply uniformly across the nation — the Commission recognises that the ATO’s approach to

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GST for ridesharing and ride sourcing drivers is both necessary and appropriate to ensure neutrality in tax treatment between competing services.

### Low value import exemption from GST

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 2015c). In August 2015, the Australian Government, with the support of state governments, announced that legislative changes will be made to remove the low value threshold for GST from 1 July 2017. It is proposed that a vendor registration model be used as a method of collecting the GST. In announcing the change, the Treasurer noted that, '[a]s goods would not be stopped at the border, administering a vendor registration model would have a relatively low cost.' (Hockey 2015c, p. 2)

### Income and the digital economy

The Australian Taxation Office provides guidelines for declaring income, including the renting of a primary residence and has a range of tools to increase compliance in income declarations more generally (Australian Taxation Office 2014). In May 2015, the Australian Taxation Office released advice about the tax treatment of income earned from sharing economy activities noting that:

... the same tax laws that apply to activities conducted in a conventional manner apply to activities in the sharing economy. (Australian Taxation Office 2015d, p. 1)

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 2015c).

## **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 of these challenges 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 design and adapt regulation in a changing environment.

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## Regulator discretion in compliance and enforcement

Consistency and predictability in regulator enforcement provides an environment of regulatory certainty for businesses to operate (knowing how to be compliant and to minimise unnecessary 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) recognised the value of discretion in enforcement noting that ‘an appropriate degree of flexibility to permit regulators to 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 to focus their activities, the approach they will take in doing that work, and 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 prescriptive. Similarly, regulators need to be resourced to attract and retain staff with the appropriate knowledge and skills to effectively undertake their role, including having the ability to exercising discretion (PC 2013c).

Businesses generally aim to comply with their regulatory obligations. Those with an innovative business model, however, sometimes claim that they are not required to comply with regulations because their business model is different and not within the scope of the regulation that applies to more traditional incumbents in the relevant sector. Furthermore, there are also times when it is unclear whether certain actions by a business are a contravention of the regulation. When faced with pressures from a number of sources, regulators typically seek to provide certainty by enforcing the existing regulations they are tasked to manage — requiring compliance by businesses and escalating the enforcement approach to match the perceived level of compliance risk involved. 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)).

### Conditions-based regulatory exemption

In an environment of rapid technological change, regulators need greater capacity to exercise discretion, in particular through the ability to provide a conditions-based

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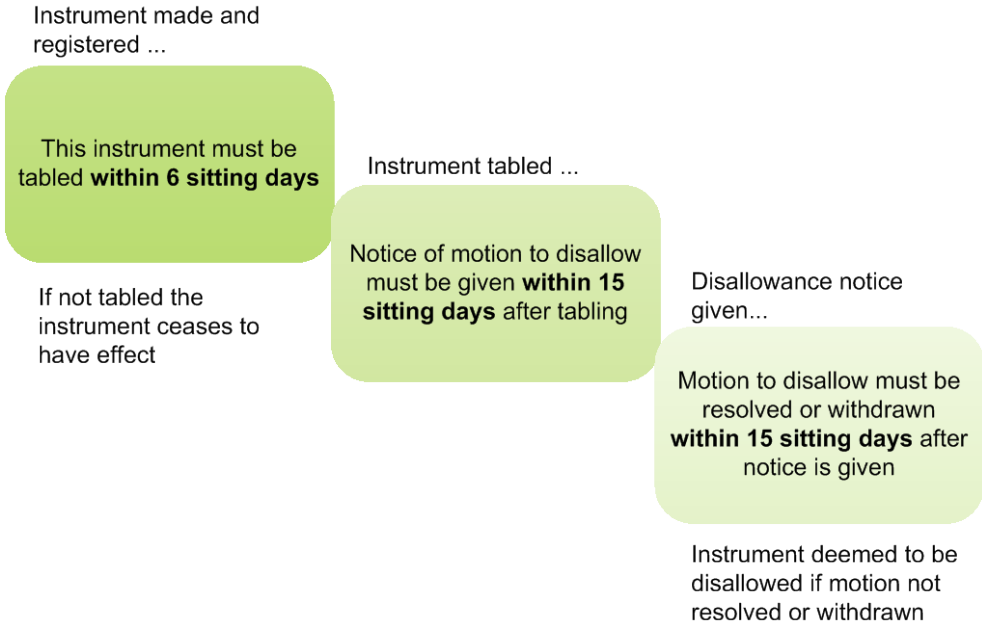
regulatory exemption to foster innovation and business entry while still ensuring overarching policy objectives are met and such an exemption would be subject to a public benefits test.

Ideally, new businesses would have to apply to the relevant regulator for a regulatory exemption prior to operating. After seeking public comment and assessing the facts within a legislated timeframe, the regulator would advise the relevant minister to approve an exemption (for a limited duration) from specific regulatory requirements for a particular business or class of businesses. This exemption would necessarily be conditional on the details of the business model remaining substantially unchanged and being carried out as described at the time of application, and relevant policy objectives (such as public safety or consumer protection) being met. Regulatory exemptions should not be denied on the grounds of protecting incumbent businesses from competition. 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. It is envisaged that a regulatory exemption would apply to regulatory requirements related to business operators, but not to taxation or fee/levy requirements.

Such an approach would require each jurisdiction to legislate to provide such powers to regulators. The delegated power to provide a regulatory exemption from certain requirement would be given to the Minister, on the advice of the relevant regulator. The resulting regulatory exemption would be a disallowable instrument and follow the usual system for such instruments in each jurisdiction (figure 8.2).

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**Figure 8.2 Usual disallowance system — Commonwealth**



Source: Parliament of Australia (2013)

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Providing a regulatory exemption — and doing so in a transparent manner — has the effect of providing certainty, facilitating business activity and the opportunity for new businesses to invest and innovate their business model, and for consumers to enjoy the benefits of these new business models. It also provides regulators an opportunity to watch and assess the risks and benefits of such activity, thereby ensuring policy objectives are maintained while determining the appropriate longer term regulatory response. A further benefit of this process is that it would provide the business with protection from legal action by competitors, not just from the regulator (but under these circumstances only for the duration of the fixed term).

A conditional regulatory exemption would work in a similar manner to wide-ranging exemption powers currently available to some regulators. For example, the Australian Competition and Consumer Council (ACCC) has the power to authorise most conduct that would otherwise be prohibited by the *Competition and Consumer Act 2011* (Cth). It has the overarching public benefit test that by granting authorisation, the benefit of allowing otherwise prohibited behaviour would outweigh the detriment to the public (in terms of lessening of competition). Similarly, the Australian Securities and Investments Commission (ASIC) has relief powers to grant exemptions or modifications to the operation of the *Corporations Act 2001* (Cth) and the *National Consumer Credit Protection Act 2009* (Cth) (box 8.9). ASIC uses its discretion to:

... vary or set aside certain requirements of law where there is a net regulatory benefit or where we can facilitate business or cut red tape without harming other stakeholders. (ASIC 2014f, p. 4)

### **Box 8.9 Bitcoin escrow facility release from regulatory obligations**

In the September quarter 2014, ASIC declared an escrow facility to not be a financial product and therefore the platform operator did not require an Australian Financial Services licence.

The escrow facility is used in the trading on a bitcoin platform — an internet based form of currency (there is further discussion of bitcoin in chapter 9). Under this facility, the person buying bitcoins transfers the agreed purchase price into an account held by the platform operator, and the seller transfers the bitcoins to be purchased into a ‘wallet’ held by the platform operator. Once the sale/purchase transaction is able to proceed, the platform operator transfers the purchase price to the seller and the bitcoins to the buyer to settle the transaction.

ASIC considered that the facility may technically be a financial product, but was cognisant that it was not a clear case. The decision to declare the facility and not require the platform operator to hold a licence was based on the:

- facility being a minor part of broader activities
- insignificant consumer risk arising from the operator not being licensed given consumers were already engaging in a relatively high risk activity of buying and selling bitcoins.

Source: ASIC (2015b)

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## 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. This tool 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 8.10). 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.

As with regulatory 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 conditions-based regulatory exemption is the preferred tool as it provides greater level of certainty for the new business models to operate — without the concern of legal action from third parties. The proposed regulatory exemption framework also provides a greater level of legislative safeguard, transparency and public scrutiny to actions that are setting aside laws passed by parliament for a business or class of businesses. Furthermore, the limited timeframe for the regulatory exemption combined with the required public review offers a pathway to an improved regulatory environment that is not necessarily available when regulators use discretion through no action letters.

### Box 8.10 **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:* ASIC (2009); Office of the Registrar of Indigenous Corporations (2013)



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## Regulatory review and reform

Regulatory discretion in the form of conditions-based regulatory exemption is a short term solution to help regulators to keep pace with market developments, creating the space to develop better long-term solutions or approaches. An undesirable alternative to this would be for governments to continue to take a patch-up approach, developing regulation on the run that caters for each particular business model that presents — in other words reacting to the characteristics of the business — rather than developing outcomes-based regulation. Ultimately, if regulations are constantly challenged or presenting barriers to businesses with innovative models entering the market, the regulation should be reviewed.

It is important that regulations are reviewed to ensure their design and implementation remain effective in achieving desired objectives. And it may be necessary to consider whether the overall objectives of the regulation remain consistent with community values and expectations, which also evolve in light of new opportunities and technology. This is not to suggest all regulation should be removed. But it is important to assess whether the means of achieving regulatory objectives could be done better or are being achieved as a result of other drivers, such as competitive market pressures or industry standards.

Over the last 20 years systematic reviews of industry specific regulation have removed unnecessary barriers to competition, but there still remains scope for further reform. In March 2015, the competition policy review (Harper Review) noted:

Although NCP [National Competition Policy] reviews and reforms made substantial progress in eliminating anti-competitive regulations, not everything was considered, and the impact regulations have on competition can change over time.

Now, more than 20 years since the Hilmer Review, and 10 years after the end of the formal regulation review processes that followed, the reform agenda needs reinvigorating. (Harper et al. 2015, p. 119)

In light of this, the 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 also highlighted some priority areas, including planning and zoning and taxi regulation. New South Wales, Victoria, Western Australia, Northern Territory and the ACT governments have announced reviews of the taxi industry regulation (following the introduction of ridesharing in Australia).

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#### RECOMMENDATION 8.1

All jurisdictions should provide a legislative framework for fixed-term exemptions to specific regulatory requirements that deter entry by business models that do not fit within the existing regulatory framework. Such regulatory exemptions should be disallowable instruments and subject to public review prior to expiry.

Legislative safeguards should be put in place to ensure the regulatory exemption does not lead to a material increase in the risk of adverse outcomes to consumers, public health and safety, or the environment.

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
- ensure that regulation and regulators are flexible and adaptive in the face of evolving technologies and business models and properly funded for this task.

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## 9 Payment systems regulation

### Key points

- Payment systems regulation safeguards the stability of the payment system; protects system users; and promotes efficiency in the operation of systems, but can act as an impediment to entry 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 and creates a disincentive for stored value payment systems to grow in Australia.
  - An enhanced, graduated regulatory framework with appropriate thresholds to provide clarity and certainty to new payment system entrants should be developed.
- 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 PSB has designated and set access regimes for a number of payment systems, including MasterCard and Visa, but in payment systems that are not designated, such as Cabcharge, competitors must approach the ACCC with access disputes or bring private court action. This leaves a potential coverage gap between monitoring by the ACCC of potential misuse of market power and a decision by the PSB to designate a payment system and impose an access regime.
  - The PSB should better facilitate applications for designation through a formal and transparent assessment process. Decisions, and the reasons for them, should be published. A framework similar to the National Access Regime is required.
- 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.
- There are a number of barriers to setting up digital currency businesses in Australia, including the development of a sound regulatory framework that protects currency users and mitigates money laundering and related risks; and the requirement to charge GST on digital currency transactions.
  - Digital currencies should be regulated for anti-money laundering and counter-terrorism financing purposes.
  - Given the ability of currency users to easily switch to overseas providers — meaning there will never be a GST revenue stream — the GST treatment impacts on the competitiveness of Australian based digital currency businesses and pushes them offshore. Digital currencies should be treated as financial supplies for GST purposes.

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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 cash, cheques, 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 payment 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 payment 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 Authorised Deposit-taking Institutions (ADIs), which may be key participants in payment systems; 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.

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Recognising that regulatory burdens can impede the 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 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.

## **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.

Innovative businesses offer a range of benefits to consumers and the wider economy (chapter 8). However, as such businesses grow — and the amount of funds they hold with deposit-like characteristics increases — the threshold at which the businesses are subject to prudential regulation as an ADI is unclear.

Widely used stored value payment systems that are deemed by APRA to be a ‘banking business’ must be authorised as an ADI — authorisation conditions may limit this to Purchase Payment Facility (PPF) providers.<sup>26</sup> 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). No minimum threshold of stored value is defined — APRA has interpreted the RBA exemptions for small stored value PPFs (see below) as also exempting them from regulation by APRA (APRA, pers. comm. 13 August 2015), but this is not explicitly published. PayPal is currently the only PPF supervised by APRA.

Uncertainty over thresholds for APRA regulation is 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 either authorised as an ADI by APRA or authorised by the RBA. To date, the RBA has not authorised 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 *Payment Systems (Regulation) Act 1998* (Cth) does not apply to: loyalty schemes; gift card

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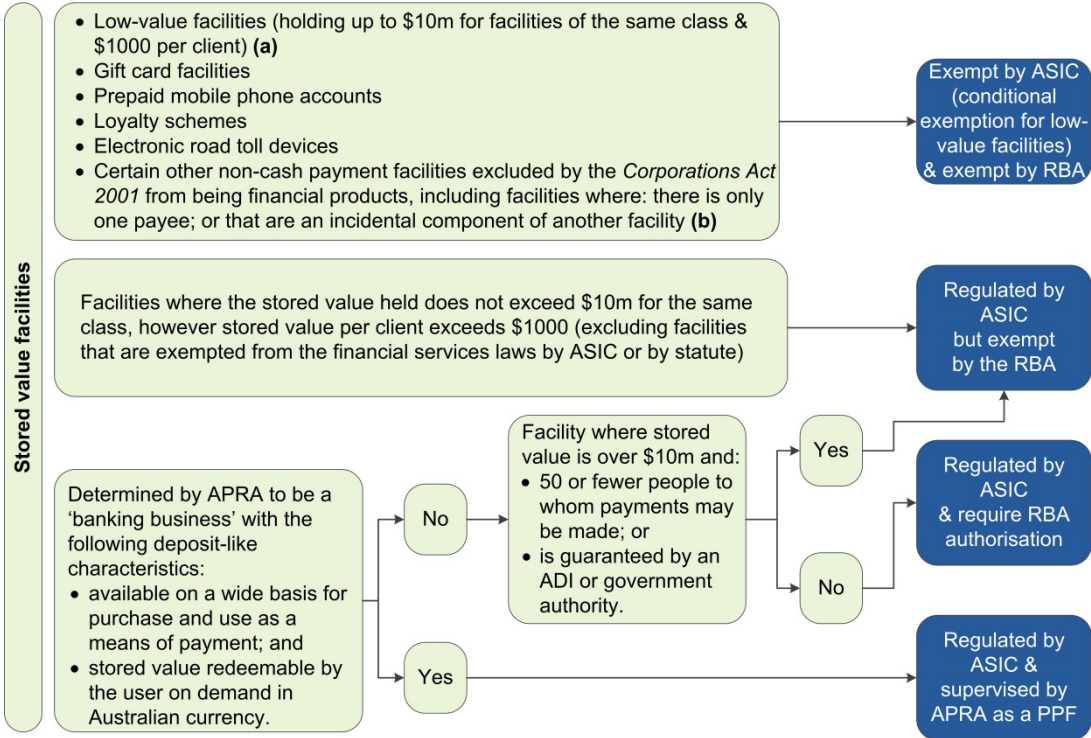
<sup>26</sup> PPF providers are a class of ADIs that can undertake a limited range of banking activities including holding stored value, but are restricted from accepting deposits for the purpose of advancing money. The stored value held by a PPF provider is subject to APRA liquidity requirements.

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. These exemptions have been provided to non-cash payment facilities considered to be simple and easy to use, well understood by customers, and pose little risk to users.

**Figure 9.1 Current regulation regime for stored value facilities**



<sup>a</sup> 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. <sup>b</sup> 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, 2014c); RBA (2015b)

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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.

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 (for example, 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 2014c, 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 \$1000.

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 with industry, 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

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— 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 along the lines 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 automatically 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.

#### RECOMMENDATION 9.1

The Australian Securities and Investments Commission, the Australian Prudential Regulation Authority and the Reserve Bank of Australia should, with appropriate industry consultation, develop an enhanced graduated framework and determine appropriate thresholds and prudential requirements for stored value facilities. The framework should be published to provide clarity to new stored value systems.

There should also be an ongoing review process or indexation of thresholds 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.

## 9.2 Access and competition in payment systems

Payment systems are characterised by large economies of scale and strong network economies. 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 Australian payment systems 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.



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### 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 payment 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<sup>27</sup> — 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).<sup>28</sup>

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<sup>27</sup> 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.

<sup>28</sup> 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-subsidise issuer costs to the detriment of specialist acquirers.

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## 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 authorised 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 payment 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 potential new entrants may be deterred because:

- access to the MasterCard and Visa payment system is limited to ADIs (when these schemes may be willing to accept non-ADI members)
- APRA's supervisory framework for SCCIs mirrors the requirements for banks and as a result is more onerous than necessary for participants in credit card systems.

As a result, the SCCI category of ADIs was discontinued 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 in identifying and designating relevant payment systems**

Underpinning the design of the existing payment 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 formally apply to the RBA to direct access to the system or to arbitrate disputes between participants. Rather, the only recourse for businesses that have a dispute about access is to approach the ACCC (for action under the

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*Competition and Consumer Act 2010* (Cth)) or bring private legal action, which for a new business is likely to be prohibitively expensive.

As a result, the existing regulatory regime leaves a gap between regulators, with one able to improve access only if presented with evidence of potential anticompetitive behaviour and the other 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.

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 assumed 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 penalties for breaches of the prohibitions on anticompetitive behaviour.

Once a payment system is designated by HM Treasury, the PSR 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 sees 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.

A prominent example of where there are concerns about access and the misuse of market power in a payment system in Australia is the Cabcharge payment system (box 9.4).

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## 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, following the case, no other payment processor was able to obtain access to Cabcharge payment products, meaning that taxi drivers have needed 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).

In 2012, the Victorian Taxi Industry Inquiry (undertaken by former ACCC Chairman Professor Allan Fels AO) 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.<sup>29</sup> Further, the 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 inquiry found that the 10 to 11 per cent surcharge on electronic payments was likely to far exceed the resource cost of providing the service and recommended that the electronic payment taxi fee should be capped at 5 per cent. A number of state governments have since placed a 5 per cent cap on surcharging for electronic taxi fare payments, including governments of: Victoria (Naphine 2014), New South Wales (NSW Government 2014a), and Western Australia (DoT 2015).

In June 2015, the ACCC accepted an enforceable undertaking from Cabcharge (ACCC 2015), which commits Cabcharge to: negotiate with third parties in good faith in relation to providing access to the system that will allow them to process Cabcharge cards; execute an agreement with third parties in accordance with the provisions set out in the undertaking; and provide any reasonable technological support requested by the third party to enable it to process Cabcharge cards. The undertaking applies for a period of five years.

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<sup>29</sup> In November 2012, CabFare also requested that the RBA designate the Cabcharge payment system and set access fees and arrangements.

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In the draft report, the Commission recommended that the Cabcharge payment system should be designated by the PSB. Since the release of the draft report, the ACCC has accepted an enforceable undertaking from Cabcharge to allow third party processing of Cabcharge cards. This undertaking appears to provide scope to address concerns regarding access to the Cabcharge payment system, although there are some potential limitations with the enforceable undertaking. These include the limited time frame of the undertaking and that third parties still need to negotiate access, with the potential for negotiations to be protracted or stymied. Another issue not addressed by the undertaking is that Cabcharge is the sole processor of taxi disability subsidy scheme instruments in some states. On the other hand, however, the RBA has noted that designation may be ineffective in addressing issues such as the high level of surcharging on Cabcharge payments (sub. DR74).

Obtaining the enforceable undertaking with Cabcharge has been a protracted process and the Commission remains of the view that designation by the PSB, and the establishment of an access regime, may have provided scope for a more timely, and potentially less costly, resolution. Promoting competition and efficiency in payment systems are explicit objectives of the PSB — along with stability and minimising risk. However, the failure to designate the Cabcharge system, or to provide an explicit rationale for not doing so, has created impressions that competition considerations are not given sufficient weight by the PSB.

As a minimum, amendments should be made to the operation of the PSB to create a more transparent and documented process for the assessment of requests to designate a payment system. There should be a clear and documented process for lodging applications and how applications will be assessed. The assessment process should include mechanisms for efficiently dealing with frivolous or vexatious applications. Decisions should be published, including reasons for either accepting or rejecting the application. There should also be a formal review process available through the Australian Competition Tribunal. The overall process should be similar to that for the National Access Regime set out in Part IIIA of the *Competition and Consumer Act 2010* (Cth).

There is also a broader question of whether there is scope to increase the responsiveness of regulation of payment systems to competition concerns, notwithstanding consideration of stability considerations. Potential models could be greater alignment of the Payment Systems Board with the UK Payment Systems Regulator, which has a more primary focus on competition objectives, or the transfer of some regulator functions to the ACCC. The appropriate path is not clear, but further consideration of this issue seems warranted. While the magnitude of the Cabcharge system might not be sufficient in and of itself to justify such changes, future technological developments in payment systems, such as smart phone-based payment systems, could create substantive competition issues.

While not singling out the PSB, the Financial System Inquiry saw a need to strengthen the focus on competition in the financial system more generally. It recommended three yearly reviews of the state of competition in the financial system (The Treasury 2014d). This review process may be an appropriate avenue to more fully examine this issue.

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#### RECOMMENDATION 9.2

The *Payment Systems (Regulation) Act 1998* (Cth) should be amended to require a transparent process for the assessment of applications to designate payment systems. The changes should include a formal application process; the publication of determinations and the reasons for each determination; and a review process through the Australian Competition Tribunal. The process should be similar to that for the National Access Regime set out in Part IIIA of the *Competition and Consumer Act 2010* (Cth).

### 9.3 Digital currencies

Digital currencies are internet-based forms of currency that can be transferred, stored and traded electronically through peer-to-peer networks. Crypto-currencies are digital currencies that rely on cryptography (technologies for secure communication in the presence of third parties) to ensure the security of transactions. There are currently at least 600 digital currencies worldwide (CoinMarketCap 2015), although most trade in very small markets (such as for electronic gaming).

The crypto-currency Bitcoin accounts for the majority of the daily trade in crypto-currencies worldwide (CoinMarketCap 2015), and is the most widely used digital currency in Australia (ADCCA 2014). Globally, the use of Bitcoin has almost doubled over the past two years — from an average of 56 800 transactions per day in April 2013 to 106 500 transactions per day in April 2015 (Blockchain 2015).

In Australia, bitcoins are accepted by around 200 physical retail businesses (of a total of around 6500 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

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another within an hour)<sup>30</sup> and is potentially less costly (averaging 1 per cent of the transaction value across all bitcoin transactions).<sup>31</sup>

### 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 users 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 have a number of potential benefits for users, including for international remittances — where conventional methods can take more than 3 days to occur and costs average around 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.

The key innovation of Bitcoin (that could have a large range of 'disrupting' applications) is the underlying technology that allows for the rapid transfer of ownership over the internet. Accordingly, reducing impediments to digital currency businesses in Australia could facilitate innovation, not only in payment systems, but also a range of other industries, including, for example, '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.

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<sup>30</sup> 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).

<sup>31</sup> 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.

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However, digital currencies also pose a risk to users. This was 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). The (often substantial) price volatility in some digital currencies also present substantial risks to digital currency users.

### **Appropriate regulatory oversight could reduce barriers to entry**

Digital currency businesses are largely unregulated in Australia. For example, ASIC submitted that digital currencies do not fit within the current legal definition of a ‘financial product’ (sub. DR58). 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 borders 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).<sup>32</sup> 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/CTF) regime regulated by the Australian Transaction Reports and Analysis Centre (AUSTRAC) under the *Anti-Money Laundering and Counter-Terrorism Financing Act 2006* (Cth).<sup>33</sup> To the extent that users convert digital currency into and out of Australian dollars (or another foreign currency)

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<sup>32</sup> 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.

<sup>33</sup> 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.



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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 (2014g, 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 this ‘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/CTF 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 based on commercial decisions by banks.

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 was 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.

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The Canadian<sup>34</sup> and US<sup>35</sup> Governments have also made moves to bring digital currency intermediaries under the relevant AML/CTF regulation. The experiences of digital currency businesses operating under the US AML/CTF regime suggests that the regulation has increased businesses' legitimacy, assisted in forming banking partnerships and investment, 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 US states forcing some of them out.

While digital currencies are currently only traded in low volumes with few businesses accepting payment in digital currency, the industry could potentially grow rapidly. Consistent with the views of the Senate Economic Reference Committee (2015a) in its inquiry into digital currencies, the Commission considers that given the money laundering and terrorism financing risks, as well as the likely low costs of regulation, digital currency intermediaries should be included in the AML/CTF regime in Australia. The presence of such regulation should also alleviate the concerns of banks and reduce the extent of de-banking (or at least that component based on legitimate risk concerns).

RECOMMENDATION 9.3

The Australian Government should amend the *Anti-Money Laundering and Counter-Terrorism Financing Act 2006* (Cth) to enable the Australian Transaction Reports and Analysis Centre to regulate digital currency businesses for anti-money laundering and counter-terrorism financing purposes.

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 its 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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<sup>34</sup> Canada introduced legislative change to require money services businesses dealing in virtual currencies to be regulated under Canada's AML/CTF regime in 2014 (FINTRAC 2014). The new regime will come into force after regulations and associated guidance are published.

<sup>35</sup> 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).

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Self-regulation was supported as an interim measure by the Senate Economic References Committee (2015a). However, it also recommended the establishment of a Digital Economy Taskforce to gather further information to help determine if and when it may be appropriate to regulate certain digital currency businesses.

### **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 digital (or more specifically, crypto) currencies that viewed digital 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).<sup>36</sup> 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) noted that this will ‘increase the paperwork that is required to report each transaction ... [and] will reduce or remove the advantage the business receives from bitcoin’s low value transaction cost’.

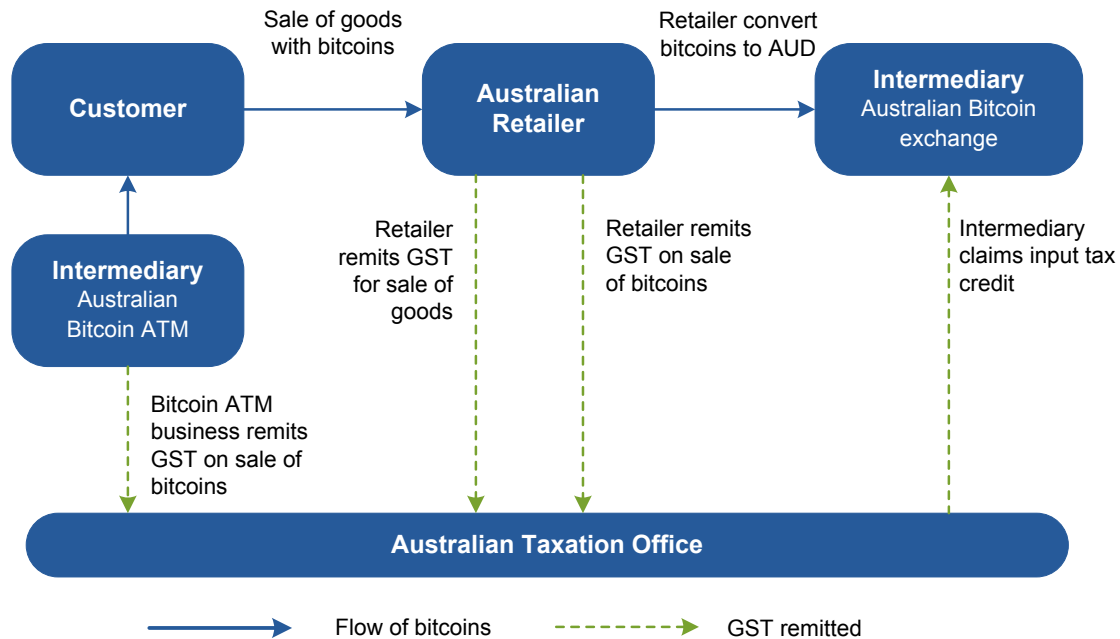
Second, when an Australian based business (such as an exchange or ATM) supplies bitcoin to an Australian customer (or non-GST registered business, which cannot claim input tax credits), GST is due on the supply of bitcoin, increasing the price of acquiring bitcoins by 10 per cent (figure 9.2). Then, when the customer makes a purchase using bitcoins, GST is also due on the sale of the goods, meaning the customer is effectively charged GST twice. This tax treatment means that 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 digital 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.

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<sup>36</sup> 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.

**Figure 9.2 Bitcoin transactions and resulting GST implications: an illustrative example**



As digital currency users can easily shift to overseas suppliers, the current classification of digital 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 note 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 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 digital currencies, including bitcoin, by using overseas suppliers and the resulting disadvantage imposed on Australian-based digital currency businesses, the Commission supports treating digital currencies as a financial supply for GST purposes. A concurrent Senate inquiry into the regulation of digital currencies has also recommended that digital currencies should be treated as a financial supply for GST purposes (Senate Economic References Committee 2015a).

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However, such a change may have implications for other regulatory regimes and there are also broader tax implications. ASIC has noted that the treatment of digital currencies as ‘currencies’ could have implications on whether digital currency transactions are considered to be financial products and hence regulated as such by ASIC (sub. DR58). The Senate Economic References Committee (2015a) also noted broader tax implications, particularly in regard to income and fringe benefits tax and recommended that these issues should be considered as part of the White Paper on the Reform of Australia’s Tax System. While changes around the treatment of digital currencies for GST purposes will assist with the set-up of Australian-based digital currency businesses, the implications of any changes on the broader regulation of digital currencies also need to be considered.

RECOMMENDATION 9.4

Digital 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 digital currency in both Division 195 of the *A New Tax System (Goods and Services Tax) Act 1999* (Cth) and relevant GST Regulations.



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# 10 Supporting entrepreneurial ecosystems

## Key points

- Governments provide a variety of assistance to new and established businesses that aims to, among other things, promote: ‘small’ businesses; and economic development and employment, including structural adjustment in particular industries or locations.
- There is a growing focus among governments in Australia and overseas on supporting start-ups. The rationale is that these businesses can create knowledge and network spillovers that benefit other businesses and the wider community, resulting in a ‘virtuous’ cycle of entrepreneurship, innovation, investment, income and employment growth.
- A common concern about current government approaches to start-ups is that they do not distinguish them sufficiently from other small or young businesses, nor do they recognise the role of entrepreneurial ecosystems.
- Governments can support entrepreneurial and innovative activity in businesses generally by ensuring that the broader economic policy environment — including regulation and assistance programs, taxation and infrastructure services — is as effective and efficient as possible.
- Any government support to entrepreneurial ecosystems should be underpinned by a due diligence assessment that a potentially viable ecosystem exists. It should also focus on the networks and connections within ecosystems; require private sector contributions; be time-limited; be subject to ongoing monitoring and evaluated against stated objectives; and be delivered by people with local knowledge and the skills to achieve desired outcomes.
  - Governments should review their programs against these principles and remove non-compliant programs within three years.
- Governments should also strengthen foundations for entrepreneurial ecosystems by addressing particular barriers facing start-ups and spillover opportunities.
  - Entrepreneurial culture can be enhanced by governments using positive language to celebrate entrepreneurial successes and affirm lessons from failures.
  - Skills and capacity can be enhanced by governments reviewing the way in which schools interact with businesses and entrepreneurs, and by universities reviewing their degrees and recruitment practices to accommodate practical entrepreneurial experience.
  - Access to knowledge and data can be improved by making government data openly available. Also needed is an independent review into Australia’s innovation system that covers: business collaboration, intellectual property management and research commercialisation practices of the public sector; business incubators in universities and publicly-funded research institutions; and transformative research.
- Universities should review the management of their alumni networks to enhance the contribution of successful entrepreneurs among their alumni back into their universities and local entrepreneurial ecosystems.

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## 10.1 Government support for new businesses is wide-ranging

All levels of government — Commonwealth, state and territory, and local – provide assistance relevant to new businesses (appendix E). Government assistance includes the provision of: information and advice; grants and subsidies; tax concessions; mentoring, skills and training; concessional loans; collaborative mechanisms; office space and facilities; and trade missions and awards. Much of this assistance is provided directly by government agencies to individuals and businesses, or by way of other bodies such as not-for-profit organisations (including industry associations), universities, and other businesses. Significantly, much government assistance is relevant — intentionally so — to the set-up stage of a business, but may also be available to established businesses.

Government assistance 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). In these cases, government support is argued to deliver improved economic outcomes relative to those that would be achieved by the market alone. Governments have also sought to address other objectives. They have long supported ‘small’ businesses, because of their perceived contribution to employment and productivity, as well as concerns that they face barriers to establishment that are specific to size. Governments have also sought to facilitate economic development or structural adjustment in particular industries or locations.

There is a long history of programs to support the set-up of social enterprises as well as of businesses by Indigenous people and communities, the unemployed and other disadvantaged groups (table 10.1). Some inquiry participants noted the particular barriers facing women and young people with respect to business set-up (Security4Women, sub. DR39; Foundation for Young Australia, sub. DR56).

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**Table 10.1 Examples of government assistance for social purposes**

<i>Measure</i>	<i>Description</i>
Indigenous Business Development Program (NT Government)	Provides financial assistance to Indigenous people to enter commercial businesses or expand existing businesses.
New Enterprise Incentive Scheme (Australian Government)	Provides accredited small business training, advice and mentoring for eligible job seekers for up to 52 weeks as well as ongoing income support for up to 39 weeks.
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.
Social Enterprise – Grants Program (WA Government)	Provides grants to new and existing social enterprises as well as support services including pre-investment and after-care support services.

*Source:* Appendix E

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## A growing focus on ‘start-ups’ — but too often misdirected

There has been a growing focus among Australian and overseas governments in supporting start-ups (table 10.2, box 10.1, appendix E). As chapter 2 notes, start-ups are the very small proportion of businesses that are highly entrepreneurial and innovative (whether tech or not tech-based), and include high growth potential businesses. While many governments are interested in start-ups, they often do not appear to have a coordinated strategy in supporting them and, to date, there has been limited evaluation of the effectiveness of programs intended to assist start-ups.

**Table 10.2 Examples of government assistance to ‘start-ups’<sup>a</sup>**

<i>Measure</i>	<i>Description</i>
Entrepreneurs’ Infrastructure Programme — Accelerating Commercialisation (Australian Government)	Provides financial and other assistance to small and medium businesses (up to \$1 million for a company) and researchers (up to \$250 000 for a commercialisation group in a research institute).
R&D Tax Incentive (Australian Government)	Provides targeted tax offsets to eligible businesses in all industry sectors — a 45% refundable tax offset for those with a turnover of less than \$20 million per annum; and a non-refundable 40% tax offset for all others. <sup>b</sup>
Minimum Viable Product program (NSW Government)	Offers matched funding of 50% of approved project costs to a maximum of \$25 000 to demonstrate an idea, prove a concept, develop a prototype or customise a solution.
Startup Queensland (Qld Government)	Provides funding of up to 50% of the total eligibility activity costs (up to \$25 000) to Queensland-based organisations to deliver practical information, advice and networking opportunities, collaboration, connectivity and ‘transformational entrepreneurship’ to the Queensland start-up community.
Advance Queensland (Qld Government)	Provides a \$180 million package of initiatives over four years to assist start-ups in the State.
Technology Development Voucher (Vic Government)	Offers grant funding of up to \$50 000 through a voucher to Victorian businesses.
Startup Victoria Initiative (Vic Government)	Pledges \$60 million to support start-ups.
Business Innovation Support Initiatives (NT Government)	Provides vouchers or grants to NT-based start-ups and microbusinesses to commence R&D in the areas of science, engineering, technology and design.
Innovation Connect (Icon) - Accelerating Innovation Grants (ACT Government)	Offers grants from \$5 000 to \$50 000 on a dollar for dollar matching basis to start-up and growth businesses for proof of technology, accelerating innovation, or clean technology.
City of Melbourne grants	Offers grants up to \$30 000 to help start-ups of ‘new and creative’ businesses located or intending to locate to Melbourne.

<sup>a</sup> Despite notionally addressing ‘start-ups’, some of these programs also apply to existing businesses. For example, the Australian Government’s Entrepreneurs’ Infrastructure Programme applies to businesses that are at least three years old. <sup>b</sup> ‘Eligible entities’ that can claim the R&D tax incentive are corporations, but not individuals, corporate limited partnerships or trusts in general.

Source: Appendix E; Andrews (2015); Queensland Government (2015c)

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## Box 10.1 International start-up policies

**Chile:** The Chilean Government launched StartUp Chile in 2010 to help turn Chile into a tech and entrepreneurial hub. StartUp Chile offers a 6 month accelerator program to Chilean and foreign entrepreneurs, which includes US\$40 000 of seed-funding, a free visa to foreigners, free office space, assistance with networking, mentoring, fundraising and connecting to potential customers and partners. It has also launched Startup Chile Scale to help start-ups graduating from its accelerator program to get investment and stay in the country.

**Israel:** The Israeli Government's initiatives to support start-ups are largely run through its Office of Chief Scientist and include: a technological incubator program to support start-ups; a matching grants program where businesses submit 'high risk' R&D proposals with grants (or loans) awarded on a competitive basis, which the businesses must pay back; and the Yozma program, which set up 10 venture capital funds contributing up to 40 per cent towards the total capital investment.

**New Zealand:** The New Zealand Government's measures to promote entrepreneurship and high-growth knowledge-based businesses include: an entrepreneur visa for foreign entrepreneurs to establish high growth businesses; a visiting entrepreneur initiative to engage experienced US entrepreneurs and angel investors; a national network of government-funded start-up incubators; grant funding of up to A\$430 000 per start-up supported by the incubators; innovation precincts in Auckland and Christchurch; a A\$150 million venture investment fund; a A\$37 million seed co-investment fund; regulatory changes enabling crowd-sourced equity funding; a Kiwi Landing Pad in San Francisco for New Zealand start-ups; and a national innovation agency to focus on high-growth technology-based businesses.

**Singapore:** The Singapore Government committed to a National Framework for Innovation and Enterprise to support the creation and growth of at least five local technology companies with annual revenue of more than \$1 billion. Framework measures include: a network of government-funded start-up incubators; an early stage venture fund which invests on a 1:1 matching basis; co investment in Singapore start-ups 85:15 (government to private sector); a national entrepreneurship education program in schools; and tax deductions for investors in start-ups.

**United States:** The US Government's Startup America Partnership aims to accelerate high growth entrepreneurship through a partnership with start-up community leaders. Partnership measures include: expanding 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; expanding entrepreneurship education and mentorship programs; strengthening communication of federally funded R&D; providing tax relief and incentives for start-ups; removing unnecessary regulatory barriers to high growth start-ups; and introducing the Impact Investment and Early Stage Innovation program.

**United Kingdom:** The UK Government's measures to support high-growth, globally-focused businesses include: business immersion programs in schools; competitions to encourage digital entrepreneurship; the establishment of a Technology Strategy Board; changes to Initial Public Offering regulations to enable higher rates of technology company listings; reduced capital gains taxes for start-up founders who sell their business; the Enterprise Investment Scheme and Seed Enterprise Investment Scheme (income tax relief and capital gains tax exemption) to support the growth of an angel investment sector; funding to stimulate the creation of new early stage venture capital funds and to encourage private sector investor investments; and funding to provide capital and mentoring for start-ups.

*Source:* Baldassarre (2015); Moss (2011); StartupAUS (2015)

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## Rationales for supporting start-ups

The rationale for government support of start-ups is that they create knowledge and network spillovers that benefit other businesses and the wider community, resulting in a ‘virtuous’ cycle of entrepreneurship, innovation, investment, income and employment growth. 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 a 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. (2014e, p. 3)

Evidence of the benefits of start-ups has tended to focus on the extent to which they create jobs — particularly, that high growth potential businesses account for a disproportionate share of employment growth. This is covered in more detail in chapter 2.

## Government support is often misdirected

A common concern about current government approaches to start-ups is that they do not distinguish them sufficiently from other small or young businesses, resulting in poorly designed policies. For example, the Australian Government’s 2015-16 Budget’s Jobs and Small Business package included initiatives to stimulate small business investment and employment, and facilitate more entrepreneurial activity. In response to the package, Sam Chandler, founder of Nitro (a software company) said:

The Australian Government seems to misunderstand the distinction between small business and start-ups. Start-ups are high-growth entities with huge potential to scale internationally. Whereas, small businesses are more localised and have fewer employees. Both entities have different needs and to have one uniform policy is to do injustice to both. (Powell 2015a)

Similarly, the US academic Daniel Isenberg said:

... as I look at the world of economic policy, I see near-universal policy confusion among self-employment, small business ownership, and entrepreneurship. Governments have SME [small to medium enterprise] programs, banks have SME teams, chambers of commerce have SME departments. We have small business administrations and micro-finance. Not only are these activities more different than not, but many entrepreneurs actually dislike being lumped together with “SMEs”; they view being small or medium as an uncomfortable transitional state that is often perceived of as a stigma that connotes a static presence as a small, second-tier supplier. Their aspiration is to sell, partner with, compete with, and outsmart the large incumbents. (2011, p. 3)

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The remainder of this chapter reflects on the growing attention given by governments to start-ups. In particular, it looks at: what might be the role of government with respect to entrepreneurial and innovative businesses and the ‘ecosystems’ in which they can thrive; and what scope there is for governments to address common ‘barriers’ facing these businesses and spillover opportunities.

## 10.2 What is the role of governments with respect to start-ups?

Many commentators consider that governments have a role in ‘entrepreneurial ecosystems’ — the typically local environments in which start-ups operate (Isenberg 2011; Mack and Mayer 2015; Mason and Brown 2013; Mazzarol 2014a).<sup>37</sup> How they do this in a way that enhances community-wide benefits is not straightforward, and is likely to reflect a range of circumstances particular to a country or ecosystem. 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. ... But for every effective government intervention, there have been dozens, even hundreds, of disappointments, where substantially public expenditures bore no fruit. (2010, p. 2)

A wide range of measures that governments can take to support start-ups have been proposed. 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).
- Mazzarol (2014a) considered that governments should focus on promoting entrepreneurial ecosystems by fostering linkages between start-ups and other ‘actors’ (for example, customers, end users, suppliers and universities) to stimulate innovation.
- Google Australia (sub. 37) considered government attention is required to address ‘weaknesses’ in that there is no national policy framework to support technology start-ups or business incubators, and that Australians are generally not taught entrepreneurial business skills at a younger age.

There are two inter-related strands of thought as to what should be the role of governments with respect to start-ups as well as to entrepreneurial and innovative activity more broadly.

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<sup>37</sup> The term has wide currency and has been used by the OECD, the World Bank, the World Economic Forum, governments, think tanks, academics and others.

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## 'Traditional' economic approaches to government assistance

There are risks associated with government intervention in markets. Governments might waste taxpayer funds by supporting activities that would have occurred anyway, or produce only modest benefits that do not exceed the cost of government intervention, and/or at worst distort market signals in a way that produces less efficient outcomes. Even with government support, some businesses will fail. Moreover, choosing to support some businesses can undermine the success of other businesses.

Traditional economic approaches to determining the role of government seek to address these risks by focusing on the extent to which there is a market failure or gap, and whether there are community-wide net benefits from government intervention (box 10.2). They also require that any government support is subject to ongoing operational practices to ensure that stated objectives are being met as well as independent and transparent evaluation.

### Box 10.2 A traditional economic approach to government involvement

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 undertake **due diligence** and 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.

Source: PC (2014g)

The main market failures that are associated with start-ups, and entrepreneurial and innovative activity more broadly, relate to the beneficial spillovers that flow from their entrepreneurial and innovative (risk taking) activity as well as from the local environments (or entrepreneurial ecosystems) in which they evolve and play a part. The following are some specific examples based on Atkinson and Ezell (2012); Lerner (2010); and Lerner and Watson (2007):

- When entrepreneurs and businesses cannot capture all the benefits of their own innovative activity, they may produce less innovative activity than the community

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needs or benefits from. The knowledge needed to create new products, processes and organisational forms cannot usually be confined completely to an individual business. It spills over to others who can use it without paying the costs of creating it. For example, an entrepreneur develops a new business model for building and selling a computer that others copy, or a business makes a breakthrough that forms the basis of innovations that other businesses can use.

- Capital market failures have caused private financing of R&D to shift away from entrepreneurial and innovative activity. While investors may be able to deal with risk, they deal less well with uncertainty where it is difficult if not impossible to model expected outcomes. These capital market failures occur when unfamiliar investments such as those involving radically new businesses, novel technologies (such as the Internet) or innovative business models appear too uncertain for investors to fund relative to the anticipated returns.
- There are coordination failures that undermine entrepreneurial and innovative activity. Because of the associated complexity, businesses cannot maximise the benefits from their activity by working in isolation. Businesses need to interact with others such as suppliers, customers, advisors, competitors, universities, governments and the like to gain various kinds of technology transfer, information and market access. Such interactions take time, effort and resources, against the backdrop of considerable uncertainty, particularly as there may be a lack of information about the most useful partners.
- The benefits of geographic/industry clusters or networks are under-realised. Clustering or networking enables businesses to take advantage of common resources (for example, research facilities, a skilled workforce or a common supplier base) and can result in better labour market matching, increased knowledge sharing and more innovation (for example, Hassan et al. 2015). Each business in a cluster or network confers benefits on other businesses in the cluster or network. Indeed, the value of the cluster or network for each business increases with each additional business who joins. However, no individual business takes the external benefits it produces into account when making its own location decisions; this can lead to less clustering or networking than is desired.
- Pioneering investors (for example, angel investors and venture capitalists) generate beneficial spillovers for others and lead the way to a ‘virtuous’ cycle of investment. They pave the way for other investors to invest in early start-up activity, providing information about the investment value of a start-up.

The existence of market failures is a sufficient, but not a necessary, condition for government intervention. Any government intervention might result in costs to the community (for example, by requiring higher taxes) that exceed the costs of the market failure. As such, determining ‘additionality’ — that is, whether any government support would induce activity additional to, or at a more optimal time than currently occurs — is another feature of traditional economic approaches.

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## Entrepreneurial ecosystems

A common criticism about traditional economic approaches to determining the role of governments with respect to start-ups is that they focus on fixing a specific market failure, and ignore the fact that start-ups operate in broader systems that can also fail (Atkinson and Ezell 2012; Dodgson et al. 2010). For example, Dodgson et al. said that an approach that recognises complex and evolutionary systems:

... shares with the free-market approach a stress on the importance of markets. But it rejects the market failure perspective dominating much innovation policy, seeing all markets as useful, but necessarily incomplete, arrangements ... government has to be actively engaged in the broader system of which the 'market' is only part and it is not market failure that is the concern but system failure. (2010, p. 34)

System failures can resemble market failures and include information asymmetries and network coordination costs, but do not necessarily arise from market activity.

Commentators and inquiry participants also considered that government approaches to supporting start-ups are often piecemeal with a lack of government recognition that start-ups operate within broader systems (Isenberg 2011; Mack and Mayer 2015; Mason and Brown 2013; Mazzarol 2014a). The problem with current government approaches, as the Australian academic Tim Mazzarol said, is that:

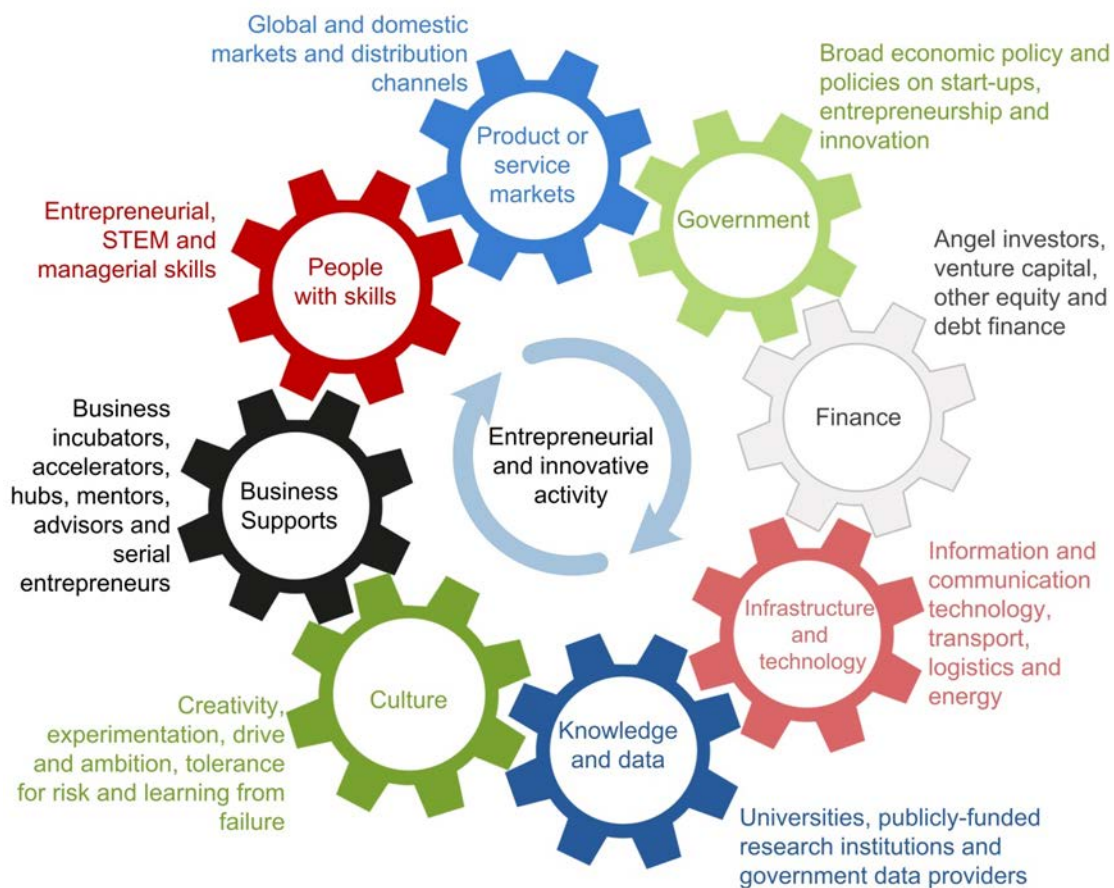
Policy is focused on growing the total number of firms and this [is] typically undertaken by investing in start-up programs. Financing policies are focused on increasing the availability of business angel and venture capital funding. Attention is also directed toward specific technologies or inventions with a strong focus on R&D, the protection of intellectual property ... rights and high-technology sectors.

Government policy also seeks to 'pick winners' by targeting funding and programs at specific parts of the entrepreneurial ecosystem (e.g. business incubators, venture capital funds, university research, or R&D) *rather than taking a more holistic approach*. Support to firms is mostly transactional in nature via grants, tax incentives and industry subsidies or assistance programs. This model is largely 'top down' in nature and driven at a national level with a few initiatives devolved to local level actors. (2014a, p. 11) (emphasis added)

The environment in which start-ups occur — the 'entrepreneurial ecosystem' — consists of a complex, idiosyncratic and self-sustaining network of formal and informal interactions that take place between a range of individuals, businesses and institutions. Ecosystem participants include entrepreneurs, providers of finance such as angel and venture capital investors, business incubators (including accelerators and hubs), business mentors and advisors, universities, and government agencies. The interactions among them can cut across a number of inter-connected domains or parts — government policy, culture, finance, markets, people with skills, knowledge and data, and professional supports (figure 10.1).

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Figure 10.1 An entrepreneurial ecosystem



Source: Based on Isenberg (2011)

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### Characteristics of successful entrepreneurial ecosystems

There is consensus among commentators (Isenberg 2011; Mason and Brown 2013; Mazzarol 2014a) on the main characteristics of effective entrepreneurial ecosystems:

- **Local or geographically bounded in nature.** Entrepreneurial ecosystems are often centred around a university campus, an area within a city, a city itself, or a region. In some, there may also be a genuine sense of ‘community’. Examples of successful entrepreneurial ecosystems are Silicon Valley in California, New York City, Boulder in Colorado, Tel Aviv in Israel, Cambridge in the United Kingdom, and Medicon Valley, a pharmaceutical and biotech cluster in eastern Denmark and southern Sweden (Compass 2015; Mason and Brown 2013).
- **Well-connected to sources of skills, knowledge and data.** Universities and publicly-funded research institutions have a role in educating and training individuals in entrepreneurship, science, technology, engineering and mathematics (STEM) and other skills as well as being important sources of knowledge and data. Skilled



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individuals can become entrepreneurs in their own right and, subsequently, advisors of and investors in new businesses. Through their involvement in business incubators, universities and publicly-funded research institutions can contribute directly to the emergence of start-ups.

A recent study by the then Department of Industry and Science (Hassan et al. 2015) confirmed the importance of sources of knowledge to new business entry on a regional basis. The study found (among other things) that: there are no Australian regions where high intellectual property generation does not occur in tandem with high entrepreneurship, with an increase in patents and trademarks in a region being positively associated with an increase in business entries; and regions that hosted a university or a publicly funded research institution — particularly a Centre of Excellence or a Cooperative Research Centre — had significantly more business entries within the professional, scientific and technical services industry than the national average.

- **Characterised by the clear alignment of roles of all ecosystem participants to pursue entrepreneurial and innovative activity.** All ecosystem participants have aligned objectives in that they seek to make money, create value and transform existing markets, services and products.
- **Inclusive and supportive, rather than competitive.** There tends to be a ‘generosity’ towards fellow participants in the ecosystem, a willingness to share knowledge and expertise, and tolerance for failure, particularly where it involves ‘fast failure’ from experimentation, or learning through failure (‘flearning’). Indeed, there is an acceptance that the quality, or speed of development, of the product is enhanced by drawing on the skills and experience of others.
- **Eventually self-sustaining.** A critical mass of successful participants reinvest in the ecosystem, which enhances the probability of future success. For example, entrepreneurs who have built their start-ups into successful businesses reinvest money, time and experience to create more entrepreneurial and innovative activity. Some of these entrepreneurs become serial entrepreneurs, establishing new start-ups. Some become angel investors, providing funding to new start-ups and sitting as directors on their boards. Others may set up a venture capital fund or become business advisors and mentors. As noted above, there may be market-based incentives for taking on these roles.
- **Well-connected to sources of early stage financing.** The way in which finance is accessed and provided is yet another characteristic of successful entrepreneurial ecosystems. Important sources of finance are angel investors and business accelerators, who provide early stage finance and hands on support to entrepreneurs (chapter 6). Finance sources also enable connections to other investors, including venture capital investors, who can provide larger and later stage funding. This staged approach to financing reduces the need for start-ups to convincingly prove early on the case for significant upfront funding, with the associated risk that important investment opportunities can be lost because of uncertainty. Investment by early stage investors signals to other investors the potential value of co-funding the start-up. Importantly,

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these early stage investors usually also bring skills and experience to the table and are more closely involved with a start-up than is the case in more traditional funding relationships.

- **Typified by parts that are working and evolving together.** Each part of an ecosystem is of equal importance, and typically evolves and grows in balance, or simultaneously, with other ecosystem parts.

The absence of one or more of these characteristics means an entrepreneurial ecosystem will fail to emerge or thrive. A well-known example was the joint proposal in 1987 by the Japanese and Australian Governments to establish a Multi Function Polis — a high ‘tech, ‘high touch’ city for the 21<sup>st</sup> century’ — in Australia (Chan 2015; Parker 1998). The South Australian site selected had no existing infrastructure, industry or services. By 1997, the proposal was eventually abandoned by the Australian and South Australian Governments at a reported cost to taxpayers of \$150 million.

### Some implications of an entrepreneurial ecosystems approach for governments

In some locations (such as Tel Aviv and New York City), the direct role of governments in enabling entrepreneurial and innovative activity is clearly acknowledged. Yet there are also countless examples of governments attempting to engender such activity from nothing and failing such as the Multi Function Polis. There are also many examples of entrepreneurial and innovative activity emerging around universities, financial districts and other anchor points with very little, if any, direct government involvement (such as the Level39 fin tech hub in the London Docklands).

A number of principles have been espoused by Isenberg (2011) and others to help guide governments in supporting entrepreneurial ecosystems (box 10.3). Together the principles promote a system-wide approach that recognises that successful entrepreneurial and innovative activity occurs within, and as part of, a complex and unique system of interacting parts, institutions and individuals — and that targeting individual elements or ‘failures’ within the ecosystem without considering the whole is likely to produce modest benefits at best. They also recognise that: government policies that do not reflect the characteristics of a particular ecosystem are unlikely to be effective; and the ecosystem is based on existing activities, and is not static, but evolves over time.

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**Box 10.3      Isenberg’s principles for governments to support entrepreneurial ecosystems**

- Entrepreneurial ecosystems are based on industries and activities that already exist.
- Entrepreneurial ecosystems are complex and evolve over time; policies should not rush the creation or development of ecosystems.
- Every entrepreneurial ecosystem is unique and determined by local conditions; the role of government will not be the same in all ecosystems.
- Policies initiatives are likely to be ineffective if introduced in isolation; they should address all entrepreneurial ecosystem parts.
- Entrepreneurial ecosystems require a blend of ‘top down’ and ‘bottom up’ policies.
- There is a need to distinguish small business policies from entrepreneurship policies.
- Policies for high growth businesses should reflect their diversity and growth paths.

*Source:* Based on Isenberg (2011); Mason and Brown (2013)

### **Bringing the strands together — the Commission’s recommended approach**

As highlighted in chapters 3 and 4, the Commission considers that, as a first priority to encouraging more entrepreneurial and innovative activity, governments should ensure the broad economic policy environment and institutions — encompassing regulation and programs, taxation, and infrastructure services — are conducive to productivity, investment and market competition for all businesses, not just start-ups.

Some commentators and inquiry participants consider that the broad economic policy environment can be a particular concern for start-ups, particularly in information and communications technology (ICT), as they are much more mobile than other types of businesses. They point out, for example, that Australia’s relative ‘tax competitiveness’ in areas such as personal income tax rates and the R&D tax incentives can affect decisions by entrepreneurs and skilled workers as to whether they move to, stay in or leave Australia. For example, Richard Baker, the co-founder of Blackbird Ventures, considers that the R&D tax incentive stops Australian entrepreneurs leaving to start their companies overseas (Baker 2015). However, others have pointed out that tax is secondary to other locational factors (such as lifestyle). The relative importance of taxation compared with other factors in influencing location choice should be considered by the Australian Government in preparing its forthcoming tax white paper (The Treasury 2015c).

Many broad regulatory and tax impediments are detailed in this report (for example, chapters 3 and 4). There is much work to be done by Australian governments to make the broad policy environment conducive to business in order for specific programs that support start-ups to have any chance of success. Priority reforms previously highlighted by the Commission and the Harper Review include: abolishing remaining tariffs; terminating

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selective industry subsidies that cannot deliver demonstrable net social benefits; limiting drought support; phasing out public sector procurement preferences; addressing restrictions on competitions with priority given to pharmacy ownership restrictions, taxi licence quotas, coastal shipping protection, and undue restrictive licensing and self-regulation of certain professional services (Banks 2012; Harper et al. 2015).

In the context of adopting an ecosystems approach to entrepreneurial and innovative activity and assessing any role for governments, due diligence requires governments first assessing that there is an entrepreneurial ecosystem of sufficient scale and quality that it could drive itself to become viable and self-sustaining with only temporary and limited government support. In the absence of this, government support is unlikely to be successful, much less lead to community-wide net benefits. Governments will need appropriately skilled and experienced people to assess entrepreneurial ecosystems.

Once governments have assessed that a potentially viable entrepreneurial ecosystem exists, they can then assess what role, if any, they might have in supporting the capture of beneficial spillovers or reducing prohibitive ecosystem transactions costs. However, the existences of spillovers and transactions costs do not of themselves justify government involvement. Governments should only intervene where they are able to move current ecosystem outcomes closer to what is considered to be socially optimal (in terms of the scale, quality and timing of entrepreneurial and innovative activity) and where there are net community-wide benefits.

To increase the likelihood of community-wide net benefits and reduce the risk of creating distortions or perverse incentives, governments should adopt appropriate operational practices. Consistent with traditional economic approaches and drawing on his observations of existing programs around the world, Lerner identified a number of principles to apply to government support of entrepreneurial and innovative activity (box 10.4). In addition to the core practices of having clear and measurable objectives, appropriate performance indicators, and monitoring and reporting, the Commission considers governments should:

- avoid the micro-managing of entrepreneurial activity, including through program criteria that prescribe particular business sizes, models, technologies or sectors
- be modest relative to the scale of the market (to avoid distorting markets and incentives or crowding out alternative funding or activities) and require private sector ‘buy-in’ that exceeds government contributions
- be limited in duration with a clear exit strategy established at the outset
- be delivered by people with relevant local knowledge, cross-sectoral skills, and capacity to generate or cultivate networks
- include frequent and transparent assessment against objectives to enable early learnings to be captured and for programs to evolve or end accordingly.

Existing assistance programs for the set-up of businesses should be reviewed by all levels of government and those that do not meet these criteria should be concluded within three years.

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**Box 10.4 Lerner's principles for government support of entrepreneurial and innovative activity**

- 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.
- 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.
- Establish appropriate evaluation mechanisms that are transparent and close to those used by private sector in evaluating entrepreneurs and investments.

*Source:* Based on Lerner (2010); Lerner et al. (2014).

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#### RECOMMENDATION 10.1

The creation of entrepreneurial ecosystems cannot be driven by governments. Where a self-generated nascent ecosystem exists and there are demonstrable additional net social benefits arising from proposed government involvement in excess of those that will naturally occur from the ecosystem, limited support addressing specific ecosystem deficiencies could be justified. In order to minimise the risk that government support distorts incentives within the ecosystem or fails to result in net social benefits, assistance should:

- be supported by an analysis of the ecosystem which identifies deficiencies and evidence that addressing these will improve outcomes
- avoid targeting particular business sizes, models, technologies or sectors and focus on strengthening ecosystems, including networks and connections between all participants
- be modest relative to the scale of the market and conditional on measureable private sector 'buy in' that exceeds government contributions
- have a clear exit strategy established at the outset
- be delivered by people with local knowledge and cross-sectoral skills
- incorporate frequent monitoring against clear objectives, and be subject to independent and transparent evaluation.

All Australian governments should, within three years, review existing assistance directed at the set-up of new businesses to ensure programs — including those for start-ups, business incubators, accelerators and hubs — are consistent with the above approach. These reviews should not be conducted by agencies responsible for implementing the programs and should be published. Those programs that are not consistent with the above principles should be wound up.

The key implications of the Commission's approach are expanded below.

#### A focus on the environment for high growth potential, but not picking winners

Some inquiry participants considered that government support should focus on new businesses, particularly businesses with high growth potential, that 'promote innovation and technological disruption' as these 'often led to the growth of new jobs and strengthening of existing industries' (PriceWaterhouseCoopers, sub. DR75, p. 3).

However, a focus by governments on supporting entrepreneurial ecosystems implies supporting the start-up environment, and this is different from supporting high growth potential businesses (or industries) directly (or protecting 'infant industries' from competition). The former approach focuses on the spillovers created within entrepreneurial ecosystems. Approaches based on 'picking winners' (or protecting infant industries) draw resources away from other businesses (industries or locations) whose activities maybe just as, or more, worthwhile from a community-wide perspective.

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A focus on entrepreneurial ecosystems avoids the difficulties of governments identifying start-ups, particularly high growth potential businesses, to be supported. It is not always easy to characterise high growth potential businesses by age (young or established), size (small or large) or sector (tech or high tech) (Audretsch 2012; Mason and Brown 2013; NESTA 2009, 2011; OECD 2014e). Moreover, some businesses may become high growth without government support or may be unlikely to become high growth even under the most favourable of circumstances, including with government support.

### Enabling networks

A focus by governments on entrepreneurial ecosystems also requires a focus on the networks or connections between ecosystem participants. As Dodgson et al. said:

The incentives and barriers to connectivity ... [form a] ... strand of the complex systems approach to innovation. How open are firms, universities, research organizations and other knowledge intermediaries to connectivity is thus a crucial issue. ... It may well be that the individuals that can facilitate the process of problem solving are in different organizations, in different economic sectors, even in different countries. That is the magnitude of the policy agenda, how to keep the parts open to the possibility of connection. (2010, p. 10)

This is compatible with the market failure perspective of traditional economic approaches, which recognises a potential role for governments with respect to beneficial network spillovers.

A focus on networks, however, does not mean that governments take a leading role in engineering or actively building these networks. Governments also need to take care not to create a plethora of networks, which crowd each other out and undermine the benefits that each network brings (OECD and EC 2015).

Were governments to initiate support for networks then it should be done in such a way that it can withdraw and allow network management and ownership to be taken over by private sector members. This is likely to build higher levels of trust and participation by members and potential members (OECD and EC 2015).

Some specific actions that governments can take to improve access to networks are discussed later in this chapter.

### Private sector contributions, with government support that is time-limited

Government support that induces sustained additional activity is more likely if it is matched by private sector contributions (whether as cash or in-kind). Additionality is more likely if private sector contributions exceeds that of governments. This ensures that there are market-based directions to governments as to where support is likely to be most valued by the wider community. It also ensures that government support is of an appropriate scale (modest) and, in particular, does not swamp or crowd out existing private sector activity.

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Moreover, as entrepreneurial ecosystems are complex and take time to evolve, any government support needs to be allowed to have effect. Having said that, there is also a need for government support to be temporary to motivate adjustment to self-sufficiency. This could be done through setting a lifespan or disband notice on government support.

An example of government support that seeks private contributions, but is temporary, is the Israeli Government's venture capital initiative, Yozma. It began in 1993 to co-invest in new venture capital funds with two partners — an experienced foreign venture capital fund manager and a local fund manager vetted by the former; Yozma put up 40 per cent of the capital and gave the other two partners the option of buying out the government at a 7 per cent interest rate. Within 5 years, 8 of the 10 funds subsequently created exercised their option, and Yozma auctioned off the remaining assets.

Yozma was gone and the government was out, with a \$50 million gain, to boot. But more importantly, by 1998 it left behind \$200 million in new funds under management, over two dozen experienced Israeli fund managers, and committed foreign venture capitalists. (Isenberg 2011, p. 12)

### What should be the roles of different levels of government?

The need for governments to understand well the specific characteristics of an entrepreneurial ecosystem would mean that any direct role for government would likely fall primarily to Australia's state and territory governments, working in collaboration with local ecosystem participants.

However, all levels of government should also consider the extent of their role in the development of broader framework elements that underpin entrepreneurial ecosystems. For example, the Australian Government has responsibility for workplace relations, migration, higher education and taxation — all of which affect the ability of start-ups to acquire skilled workers locally and from abroad.

#### *Delivery by people with local knowledge and the right skills, but not necessarily by local governments*

Whatever the level of government providing any support, delivery by people with local knowledge and cross-sectoral skills and capacity including an ability to manage risk and experimentation are necessary given the characteristics of entrepreneurial ecosystems.

Local governments have in principle a natural role in delivering any support to entrepreneurial ecosystems. They have information and awareness about specific local population needs, and can engage and coordinate local stakeholders such as local chambers of commerce, businesses, universities not for profit organisations. As the OECD said in relation to entrepreneurial skills development:



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Local governments ... are often best-placed to identify the specific needs of potential entrepreneurs. This can especially be so when they bring all relevant actors together to ensure that support is co-ordinated and cohesive. (2014d, p. 16)

Indeed, the entrepreneurial ecosystems of Berlin, New York City, London and Tel Aviv involve participation and support by local and regional governments (City of Sydney 2015).

However, there are challenges with Australian local governments having a leading role. Few exist that are of a size and geographic coverage, or have the financial or broader resourcing capacity to deliver support to entrepreneurial ecosystems. For example, given its geographical area of responsibility, Brisbane City Council may be in a better position than other Australian capital city councils (such as the Sydney City Council, one of 41 councils within Sydney) to have a leading role with respect to its local entrepreneurial ecosystem (all of Brisbane).

An example of an approach to the local delivery of government support is the Canberra Innovation Network. As noted below, the Canberra Innovation Network is managed by a separate entity established by the ACT Government with representatives drawn from the Government, local universities and publicly-funded research institutions. Its current chairman and chief executive officer have held a range of roles in the private, not-for-profit and public sectors.

### *Generating ideas on how governments could support ecosystems*

While it is not possible to be prescriptive about the role of different levels of government or the types of support each should provide, a ‘bottom-up’ approach to determining the types of support needed by an ecosystem could be beneficial. There are different versions of how this could be done, but an essential feature is to draw on input from a range of relevant ecosystem participants and the wider local community to identify key areas of action in their ecosystem.

Questions such as the following could be asked: How can engagement between start-ups and local universities be improved? The ideas, however, would need to be moderated by government against the principles set out above. As an example, CSIRO’s recent Strategy 2020: Australia’s Innovation Catalyst was based on crowd sourcing the ideas from more than 7000 of its ‘creative people, customers, thought leaders and the public’ to help answer the question of what CSIRO will deliver to Australia when it turns 100 in a decade (2015, p. 3).

### **Monitoring and evaluation**

Any government support is more likely to be effective and efficient if it is subject to frequent monitoring to ensure that government objectives are being met and to rigorous, independent evaluation. To this end, it is important that there are sensible and measurable

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outcomes in place to assess effectiveness and net community-wide benefits, supported by high quality data.

For example, in order to evaluate the effectiveness of business incubators (and government support for them), it is necessary to go beyond such narrow measures as the number of start-ups that are housed within the business incubator, the number of people employed by the start-ups, and the capital they raised, to consider what would have happened in the absence of the incubators (and in the absence of government support). Suitable methods for evaluating the effectiveness of business incubators are before-and-after comparisons and the use of a control group. The effect of business incubation can then be estimated from the average performance difference of businesses that are supported compared with similar businesses that receive no support. An example of such an approach is the 2013 quantitative evaluation of the New Zealand Government's Incubators Support Programme (MBIE 2013).

### **10.3 Specific barriers and spillover opportunities**

A number of specific barriers and issues are said to face start-ups. When considering any role in addressing them, governments need to take account of the principles laid out in section 10.2. In particular, they need to be aware that solutions may not be the responsibility of governments, but lie with other entrepreneurial ecosystem participants.

#### **Entrepreneurial culture**

There are widespread concerns about Australia's cultural attitude to entrepreneurship. For example, some commentators have claimed there is low regard by Australians towards entrepreneurs. Lerner et al. noted from their interviews with experts on the Queensland 'entrepreneurial landscape' that:

One pervasive concern involved the lack of esteem in which Australia held entrepreneurs. Much of this opprobrium was ascribed to individuals such as Alan Bond, whose chicanery had given 'entrepreneur' an unsavoury overtone. (2014, p. 92)

It is also often claimed (for example, Lerner et al. 2014; PwC 2013) that Australia has a reputation as a risk averse culture, particularly 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

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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)

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 (Acs, Szerb and Autio 2015; EO 2015; OECD 2015a; 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’; perceptions of ‘high status to successful entrepreneurs’; and individual attitudes to ‘fear of failure’ (appendix E).

### Is there a role for governments in improving entrepreneurial culture?

Entrepreneurial and innovative activity is more likely to occur if the wider community, including its institutions, supports risk taking in the pursuit of innovation and the commercialisation of ideas and tolerates failure; that is, if there is an entrepreneurial culture.

There are a number of measures that governments can take to support an entrepreneurial culture in Australia. One is through the use of positive language by all levels of government in describing all aspects of entrepreneurial activity, particularly to celebrate entrepreneurial successes and to reinforce the learning experiences of entrepreneurial failures. As an example, the Singapore Government offers a ‘Phoenix’ award to lift the social stigma against failure by recognising a tenacious entrepreneur who surmounted initial failure (Lerner et al. 2014, p. 102).

However, words that are not backed by action can have little impact on entrepreneurial culture. In this light, reforms to Australia’s personal and corporate insolvency regimes (chapters 12 to 15) can, in the long-term, lead to a change in the perception of business failure, and encourage entrepreneurs to start again.

Another measure is for governments to not automatically exclude entrepreneurs who have failed in their start-ups from participating in assistance programs (other than where there has been malfeasance). Rather a case-by-case approach should be adopted, aimed at understanding the reasons for past failure and the extent to which this previous experience increases the likelihood of future success. As noted in chapter 1, previous business set-ups has been shown to increase the likelihood of success in subsequent businesses (Gompers et al. 2010; Lafontaine and Shaw 2014).

Developing broader and deeper entrepreneurial skills through education and training programs as well as strengthening the incentives facing academics in universities and

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publicly-funded research institutions towards the commercialisation of their research are additional measures, which are considered below.

## **Access to people with skills**

The availability of people with entrepreneurial skills and skills in science, technology, engineering and mathematics (STEM) is widely seen as essential for entrepreneurial and innovative activity.

### **Entrepreneurial skills**

Key generic entrepreneurial skills are largely independent of the nature of business activity and can include: business planning; general business skills such as marketing; bookkeeping; financial acumen; project management skills; awareness and perceptions of opportunities; and socio-economic skills such as self-confidence, leadership, creativity, risk propensity, motivation and resilience (OECD 2014d; Valerio, Parton and Robb 2014).

There is mixed international evidence as to how Australia performs in terms of entrepreneurial skills and capacity. According to the Global Entrepreneurship Monitor 2014, when compared with the United Kingdom, the United States and Canada, Australia did not score well on primary, secondary and post-secondary education for entrepreneurship (appendix E). On the other hand, according to the OECD's Programme for International Student Assessment in 2012 (OECD 2014b), 15 year old Australian students performed well in problem solving particularly compared with England and the United States, with a higher proportion who were top problem solvers and a lower proportion who were below proficiency.

There are concerns that Australia's education system is not providing young people with necessary entrepreneurial skills (for example, Google Australia, sub. 37; Foundation for Young Australians, sub. DR56) and acts as a barrier to innovation and creativity (Trowbridge 2013). Many argue for Australian governments to support entrepreneurship education and training programs, particularly in schools:

- Google Australia (sub. 37) considered that governments need to ensure 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 some Australian and US schools.
- StartupAUS (2015) considered that the Australian education system is geared to preparing students for the workforce rather than starting businesses. It drew attention to international examples (appendix E) and called for the implementation of a national program of entrepreneurship education in all schools and universities.
- The Office of the Chief Scientist (2014b) recommended that the Australian Government support entrepreneurship courses in higher education institutions, the integration of innovation and entrepreneurship into mainstream school curricula and

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assessment, and the promotion of business innovators and research entrepreneurs as national role models.

- The Foundation for Young Australians (FYA 2015, p. 32) urged governments to embed ‘enterprise skills’, especially problem solving, creativity and social intelligence, in school curricula; and training teachers in problem solving methods.

There are already a number of entrepreneurship education and training programs in Australian schools and universities, some sponsored by the not-for-profit and private sectors.

- Although entrepreneurial education and training is not specifically part of the national curriculum for schools, there are school-based programs such as Startup Weekend (for schools), Startup Apprentice, Club Kidpreneur, and \$20 Boss funded by not-for-profit organisations and/or businesses. Some of these programs involve limited government support (Google Australia, sub. 37; StartupAUS 2015).
- Most universities provide courses in entrepreneurship or small business management (appendix E). Specific examples of university programs include the University of Sydney’s Graduate Certificate in Innovation and Enterprise and Technology Venture Creation courses and Flinders University’s New Venture Institute, which offers entrepreneurship courses. Some governments provide targeted funding for these kinds of programs. Entrepreneurship might also be taught in faculties other than business schools — for example, the University of Sydney’s Department of Electrical and Information Engineering has a unit called ‘Entrepreneurship for Engineers’.

## STEM skills

STEM skills are seen in Australia and overseas as essential to start-ups and to developing innovations more broadly.<sup>38</sup> For example, the Office of the Chief Scientist (2014b) noted international research, which indicates that 75 per cent of the fastest growing occupations now require STEM skills and knowledge.

As with entrepreneurial skills, there have also been calls for governments to increase STEM skills capacity in the community through measures such as introducing STEM programs in schools and universities, enabling skilled migration, and writing off HELP debts incurred by university students who study STEM subjects.<sup>39</sup>

Arguments in favour of government support centre around the economic contribution of STEM skills. For example, the Office of the Chief Scientist (2014b) reported estimates that

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<sup>38</sup> For example, Google Australia, sub. 37; Lerner et al. (2014); Levin (2014); Office of the Chief Scientist (2013, 2014b); PwC (2013)); and StartupAUS (2015).

<sup>39</sup> For example, Google Australia, sub. 37; Deloitte Access Economics (2015); Foundation for Young Australians (FYA 2015); Norton (2015); Office of the Chief Scientist (2013, 2014b); and StartupAUS (2015).

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scientific and technological advances have produced roughly half of all US economic growth in the last 50 years, and that 65 per cent of Australia's economic growth per capita from 1964 to 2005 can be ascribed to improvements in the use of capital, labour and technological innovation largely made possible by STEM. PriceWaterhouseCoopers has estimated that shifting 1 per cent of the workforce into STEM roles would add \$57.4 billion to GDP (net present value over 20 years ignoring the costs of implementation) (PwC 2015a).

There have also been concerns about the ability of start-ups to access people with STEM skills. Specifically, the Commission has heard that there is a 'shortage' of necessary STEM skills in Australia, acquiring STEM-skilled workers is a major expense, and/or businesses are unable to compete on a global market to attract workers with STEM skills to Australia (appendix E). However, the need to pay skilled workers higher wages in order to attract/retain them from overseas is evidence of a market functioning. Moreover, concerns about STEM 'skill shortages' sidesteps poor employment outcomes for current STEM graduates (Norton 2015).

There is evidence to suggest that Australia performs relatively well in many areas of STEM when compared to other countries (appendix E). For example, according to the OECD's Programme for International Student Assessment, Australia ranks 7<sup>th</sup> in science and equal 13<sup>th</sup> in mathematics out of 65 countries (Marginson et al. 2013). However, Australia's overall STEM performance does not appear to be improving. For example, according to the Trends in International Mathematics and Science Study, the participation of Australian year 12 students in STEM has consistently declined for a number decades (Office of the Chief Scientist 2014a).

The Australian Government and various state and territory governments currently support STEM programs in schools and universities and/or have strategies to improve STEM skills within the community.

- Education ministers have recently agreed to collaborate nationally in developing a STEM school education strategy for increasing STEM participation in schools (Education Council 2015).
- As part of its Industry Innovation and Competitiveness Agenda, the Australian Government announced extra funding to foster further primary and secondary student engagement with STEM (Australian Government 2014d). Specific initiatives are 'Mathematics by inquiry' programmes for primary and secondary schools, the 'Coding across the curriculum' programme, the provision of seed funding to pilot an innovation-focused 'P-TECH' styled education facility for secondary schools, and summer schools for STEM students.
- The Queensland Government's STEM Strategy (StartupAUS 2015, p. 47) includes supports to address 'challenges' such as the retention of students, performance of students, teacher capability, and valuing the teaching profession. Supports include STEM in Action grants of \$15 000 to schools to implement research-informed innovations in STEM.

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In addition to these government measures, the not-for-profit and private sectors have also supported STEM programs in schools and universities — for example, Cisco Australia’s AUSTEM 2020 and learnable.com’s Learnable for Schools programs.

### Is there a role for governments in improving access to skills?

The role of governments in boosting entrepreneurial and STEM skills is not just about addressing beneficial spillovers from entrepreneurs and increasing the propensity for entrepreneurial and innovative activity. It is also about building skills that enable the workforce and the wider community to adapt to future economic opportunities and the rapid pace of technological change.

It is important for governments to consider the time dimension of measures to boost entrepreneurial and STEM skills. Measures that have the potential to improve the short-term availability of people with skills include easing temporary migration requirements, encouraging collaboration between people with complementary skill sets, and ensuring that the regulation of workplace relations is effective and efficient.

With respect to temporary migration requirements, an area of Australian Government responsibility, the Commission notes recent reforms to the 457 visa programme to ‘strengthen its integrity and address genuine skill shortages’ (Cash 2015). Other countries (for example, Chile, South Korea, Singapore, New Zealand, the United Kingdom and the United States) have gone further and relaxed their immigration requirements specifically to encourage foreign entrepreneurs to come and set up businesses (City of Sydney 2015). Whether Australia follows this path or not requires careful assessment of all the trade-offs involved. Such issues are within scope of the Commission’s current inquiry on migrant intake into Australia.

Measures with potentially longer-term impacts on skills availability include education and training programs in universities (medium term) and in schools (long term). However, there appears to be limited evidence on the effectiveness or efficiency of government support for education and training programs, or on their longer-term outcomes (appendix E). For example, studies of entrepreneurship education and training programs in universities and schools reviewed by the Commission have generally found very modest short-term beneficial outcomes, including in terms of affecting individual attitudes to, and the likelihood of, setting up a new business. Some studies reviewed found adverse outcomes. Oosterbeek et al. (2008) found that Dutch university students participating in the Dutch Association Jong Ondernemen program were more likely to form negative intentions towards entrepreneurship and have lower self-assessed enterprise skills. There also do not appear to be any rigorous evaluations that have considered whether government supported programs delivered net benefits to the community.

Universities have a discretion under Australian Government funding arrangements as to whether, and how they offer programs — with many currently offering entrepreneurship and STEM programs. More broadly, the Commission is of the view that there is scope for

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universities to consider the potential for greater flexibility in terms of: the length and structure of courses and degrees to better accommodate the practical entrepreneurial experience of students (enabling them to move in and out of study and business); and to ensuring that entrepreneurship programs are delivered by people with the right skills and experience (such as entrepreneurs). The latter will require universities to ensure their selection criteria for recruitment has an increased focus on entrepreneurial skills. These measures are in keeping with suggestions by the OECD (2010) and Mazzarol (2014b).

With respect to entrepreneurship and STEM learning in schools, there does not appear to be strong evidence in support of additional government support. Any strengthened government requirements for such learning in schools would necessitate a change in the Australian Curriculum. However, there are wider considerations in setting the curriculum, and curriculum changes may not necessarily address a fundamental issue of how entrepreneurship and STEM learning is delivered by schools and their teachers, or indeed whether such learning is likely to result in additional start-up activity. Accordingly, the Commission considers that governments should review how their schools currently interact with the community, including businesses, to deliver entrepreneurship and STEM learning including in terms of practical learning. Such reviews should consider whether there are the barriers to such interactions, and options for addressing them that would result in net community-wide benefits.

The Commission notes that some businesses have developed innovative ways in which to attract and retain skilled workers, such as through offering equity shares in start-up businesses and other non-wage benefits. The Australian Government's proposed reforms to the regulation of employee share schemes may enhance the ability of Australian start-ups to compete with other countries to attract and retain talented staff (chapter 6).

#### RECOMMENDATION 10.2

To support an entrepreneurial culture, and build future skills and capacity:

- governments should use positive language to describe start-up success and failure that is associated with 'trying again' and 'learning by doing'
- state and territory governments should review the ways in which schools interact with the business and entrepreneurial community and any barriers to this happening
- governments should not deny access to any assistance programs solely because an entrepreneur has had an unsuccessful business venture in the past
- universities should review the length and structure of their degrees to accommodate practical entrepreneurial experience of students
- universities should review their recruitment, performance assessment and promotion policies to ensure an increased focus on entrepreneurial capabilities and business experience.



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## Access to knowledge and data

As noted earlier, a characteristic of successful entrepreneurial ecosystems is that they are well-connected to sources of knowledge and data. Important sources are universities and publicly-funded institutions (such as CSIRO, medical research institutes and cooperative research centres) that generate research that is transformative or able to be commercialised; and government agencies that collect data in the course of carrying out their functions. While entrepreneurs, investors and other ecosystem participants can also be important sources, the knowledge they share with others in ecosystems are not typically transformative or able to be commercialised.

### Research commercialisation by universities and publicly-funded research institutions

Australia's research sector (including universities, publicly-funded research institutions and businesses who conduct research) is globally recognised for conducting high quality research (Australian Government 2014a). In terms of publications, the sector was responsible for 3.9 per cent of total global research output in 2013 — this ranks Australia as 9<sup>th</sup> amongst OECD member countries, despite only accounting for 0.3 per cent of the world's population (Australian Government 2014a). In addition, Australia's higher education expenditure on R&D as a proportion of GDP is also above the OECD average (Mazzarol 2014c).

However, Australia's high levels of innovation and 'research excellence' have failed to translate well into successful commercial outcomes. According to the Global Innovation Index Innovation Efficiency Ratio, Australia ranks 72<sup>nd</sup> out of 141 countries for the efficiency with which it converts innovation inputs into innovation outputs (Cornell University 2015). In addition, Australia ranks second lowest of 17 OECD member countries in terms of creating new-to-the-world innovation (Australian Government 2014a). Australia also performs relatively poorly in terms of a number of patent intensity indicators when compared to global leaders such as Germany, the United States and China (WIPO 2014).<sup>40</sup> Finally, while the number of Australian start-ups created by universities and publicly-funded research institutions is increasing, the number of start-ups formed per \$US100 million research expenditure is declining, and Australia still lags behind Europe, Canada and the United States (Department of Industry and Science 2015).

Several key reasons have been given for the poor commercialisation of research in Australia.

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<sup>40</sup> However, patenting activity may not be the best measure of innovation in an economy. Not all innovations are formally protected, and many patents are never commercialised (Jaffe and Le 2015). The existence of patents may also inhibit innovation by non-patent holders. That said, in the absence of patents, there can be reduced incentives to innovate.

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First, it is argued that there are poor relationships and connections between Australian researchers and businesses (Australian Government 2014c, 2014c; PwC 2015b) that prevent businesses from accessing new technologies and highly skilled people (Dowling 2015). This is evident by Australia having a ranking of last out of 33 OECD member countries on the share of businesses who collaborate with research institutions (appendix E), and a ranking of 23rd out of 32 countries on the share of total research publications co-authored by industry and the research sector (Australian Government 2014a). However, it has been suggested that the relative lack of connections with the business community in Australia may be an issue of scale, and not due to a ‘lack of effort’ (PwC 2015b). Scale issues are considered later in the chapter.

A second reason given for poor research commercialisation is that Australian researchers typically do not have a business background (Australian Government 2014a), which can in turn affect communications between researchers and businesses as well as impede the ability of researchers to recognise start-up opportunities.<sup>41</sup> For example, the proportion of Australian researchers working within the business sector (around 30 per cent) is relatively low compared to other countries such as Germany, Sweden and Canada (PwC 2015b). There is also a lack of mobility between the research sector and industry (Australian Government 2014a), and appointments to senior teaching and research posts are often based on selection criteria that precludes people with a business background.

Third, it is argued that the approaches of a number of Australian universities and publicly-funded research institutions to managing their intellectual property (IP) are not conducive to research commercialisation. Under current funding approaches, universities are claimed to have an incentive to be protective of, or overvalue, their IP in order to extract as much revenue as possible (Go8 Australia 2015; PwC 2015b), which could result in long and expensive negotiations that prevent deals from being completed.

Fourth, it is argued that technology transfer offices (TTOs) in universities are not functioning as well as they might due to resourcing and other constraints (Mazzarol 2014c). TTOs assist in identifying, protecting and marketing ideas with commercial potential created within universities (ANU 2015). These offices have the potential to improve collaboration, and can address the issue of universities taking too long to relinquish ownership of IP when realising they are unable to commercialise a product (PwC 2015b). TTOs can also reduce transaction costs by providing standardised IP agreements (The University of Sydney 2014) as well as challenge traditional academic norms by promoting an entrepreneurial culture (Dodgson and Staggs 2012).

A final reason is that the current ‘reward structure’ for university academics may be discouraging the commercialisation of research. University promotion policies provide researchers with an incentive to have their work published in peer reviewed academic journals, but tend to provide little or no recognition or incentive for successfully

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<sup>41</sup> In contrast, the Commission has been told by inquiry participants it is common for university academics in the United States to have business backgrounds or be generally connected to industry.

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commercialising research or collaborating with industry (PwC 2015b). Similarly, international rankings and comparisons of universities tend to be based on the volume and quality of publications, and do not consider outcomes from research such as job creation or product income (PwC 2015b).

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**Box 10.5 Some initiatives to encourage research commercialisation**

- In its Strategy 2020, CSIRO is seeking to boost Australia's innovation performance through various approaches. These include increasing its contribution to the mobility and exchange of people and know-how between research, industry and government; and implementing a 'transformative' innovation program, new investment models and funding to accelerate its entrepreneurial capacity and provide new models for its customers to adopt technology, knowledge and services (CSIRO 2015).
- Many universities have established or are funding business incubators (appendix E) to encourage start-ups by their students, academics and other staff (and others in the community). Services provided by these business incubators range from providing co-working spaces, to providing mentoring and advice, to injecting equity funding into start-ups.
- The Australian National University and the University of Canberra sponsors a Discovery Translation Fund, which provides grants of up to \$50 000 towards proof of concept research originating from these universities (ANU Connect Ventures nd). The grants do not require matched funding or repayment.
- The Australian Government's 'Boosting the Commercial Returns from Research' strategy launched in May 2015, includes the:
  - National Collaborative Research Infrastructure Strategy, which provides research facilities to foster collaboration between researchers and industry around major strategic projects the National Collaborative Research Infrastructure Strategy, which provides research facilities to foster collaboration between researchers and industry around major strategic projects (Mazzarol 2015)
  - IP Toolkit for Collaboration, which provides guidance and tools for researchers and aims to simplify discussions with industry around IP rights (Department of Industry and Science 2014)
- a commitment to an Australian Government review of research training, aiming to prepare researchers for working productively with industry (Australian Government 2014a).
- The Australian Research Council now includes research commercialisation in its selection criteria for its funding of a number of schemes under its Discovery Program (ARC 2014).
- The University of New South Wales' 'Easy Access IP' policy makes the majority of the University's IP freely available to businesses, requiring only that users accredit any successful development of it to the University (UNSW 2015). As such, the policy broadly recognises that much of the IP generated by a university is not commercialisable, and that making the majority of IP freely available increases the likelihood of successful development of products and services of benefit to the wider community. This can, in turn, enhance a university's reputation, which may attract more students and more donations from alumni and others.

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Governments, universities and publicly-funded research institutions in Australia are increasingly turning their attention to addressing these concerns through a range of initiatives to enhance research commercialisation (box 10.5).

Another type of initiative evident overseas is the use of private sector (commercially-oriented) intermediaries to develop and commercialise research. For example, in the United Kingdom, the IP Group was established with the purpose of developing IP and innovations emerging from partner universities (IP Group 2015). Under this model, the company provides venture capital funding in exchange for the first right of refusal to invest in any IP generated within the university. Similar examples exist in the United States, where many universities sit within large networks of venture capital businesses (Croce, Grilli and Murtinu 2013).

### Transformative research

Transformative research undertaken by universities and publicly-funded research institutions can be an important source of innovations resulting in new businesses, products and markets. Mazzucato noted, for example, that every technology that makes the Apple iPhone ‘smart’ (the Internet, GPS, touch screen display, Siri) was funded by governments (Mazzucato and Penna 2015; Mazzucato 2015). She argues that transformative research by research institutions is more likely to have this kind of impact if they are well-funded by governments and ‘mission-oriented’ (in a transformational sense).

Transformative research is defined by the US National Science Foundation as:

... research driven by ideas that have the potential to radically change our understanding of an important existing scientific or engineering concept or leading to the creation of a new paradigm or field of science or engineering. Such research is also characterised by its challenge to current understanding or its pathway to new frontiers. (NSF 2010, p. 9)

There are concerns that current approaches by governments around the world to research funding and the governance of research institutions are not conducive to the undertaking of transformative research. For example, Elrahman and Giannopoulos considered that in most ‘research governance systems’:

... concerns over the need to generate the maximum return on investment, and increasingly constrained resources, lead research governance bodies to give priority to principles, operating practices and research contracts and protocols that create stifling boundaries that tend to suffocate rather than induce creativity while they institutionalise organisational cultures that do not tolerate failures or risk taking. (2011, p. 69)

Examples for supporting transformative research can be seen in the United States. The US National Science Foundation supports basic research by individuals and collaborative groups that results in transformative advances in science and engineering, seeks proposals for transformative research, and provides support through a variety of grants and programs (NSF nd). The US National Institutes of Health also provide funding to support scientists who propose ground-breaking, innovative, original or unconventional research in

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the field of health and medicine (NIH 2015). The US Government's Advanced Research Projects Agency in its Department of Energy (ARPA-E) was established to advance high-potential high-impact energy technologies that are too early for private sector investment (ARPA-E 2015). ARPA-E funds research that can have 'transformational impacts' rather than 'basic or incremental' research, and is modelled on the US Government's Defense Advanced Research Projects Agency, which is credited with such innovations as the GPS, the stealth fighter and computer networking.

## Government data

In carrying out its functions, governments collect and produce a wide range of 'administrative data' that could potentially be used to generate new entrepreneurial and innovative activity. For example, there are data on: geographical mapping features; weather observations; infrastructure usage and performance (the location and quality of broadband connections, real time road traffic and public transport flows); community and health services and outcomes; educational services and outcomes (student test data, school attendance rates, higher education enrolments and completions); and land tenure and pricing.

Many Australian governments have 'open data' initiatives and policies (for example, Department of Finance 2014). Open data are: freely available to download in a reusable form; licensed with minimal restrictions on reuse; well described; provided in an open format; and managed by the provider (ANDS 2015). One type of initiative is the provision of open data through 'portals'. For example, the Australian Government has a number of open data portals including the Australian Spatial Data Directory, the Australian Bureau of Statistics data service, and the Bureau of Meteorology's weather and other environment data services.

Another type of open data initiative, of specific relevance to start-ups, is the release of data through 'hackathons' — competitive events in which computer programmers and others involved in software development collaborate intensively for a short period of time to find a technological solution to solve a particular problem. For example, the Australian Government, and other state and territory governments, sponsor 'GovHack', which is a national open data competition, with over 2000 participants in 2015 across over 30 locations in Australia and New Zealand. Another example is the NSW Transport Department's Codeworks hackathon in 2014, which released data on real-time road and traffic information to seek app-based solutions to traffic congestion in Sydney (Deloitte Digital 2015). Winners of the Codeworks hackathon were able to own the intellectual property, received business incubator support, and were expected to have their apps released into the market.

Despite the positive developments in open data initiatives and policies, there have been concerns that governments have not gone far or quickly enough. Blue Chilli said:

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The pace startups need to move at means they can't afford to wait extended periods of time for bureaucrats to decide whether or not they're going to make data publicly available ... Governments need encouragement to keep making more data sets publicly available and it needs to be nudged to keep the data sets current and relevant. (Heber 2014)

As a specific example, inquiry participants told the Commission that property sales data held by governments are still not freely available. This is borne out by an international report, which indicates that Australia performs poorly with respect to open data availability on land ownership compared with the United Kingdom, New Zealand and Canada (World Wide Web Foundation 2015).

### Is there a role for governments in improving access to knowledge and data?

There is currently an extensive array of government (largely Australian Government) funding arrangements and other initiatives applying to research by universities and publicly-funded research institutions. These exist alongside the practices applied by the institutions themselves to collaboration, intellectual property management and research commercialisation, as well as their role in establishing business incubators.

While a detailed examination of these funding arrangements, initiatives and practices is beyond the scope of this inquiry, the Commission notes that they can have a direct impact on the formation of start-ups. Within that context, it considers that an independent review by the Australian Government is required into the innovation system, which should include among other things:

- the business collaboration, intellectual property management and research commercialisation practices of the public sector, including universities and publicly-funded research institutions
- business incubators (including accelerators and hubs) in universities and publicly-funded research institutions
- the public funding and provision of transformative research, including that by universities and publicly-funded research institutions.

Within each of these areas, the review should: address whether, and to what extent, there are barriers to the formation of new businesses, including start-ups; and identify leading practices and approaches.

The Commission also supports government open data initiatives provided that privacy and confidentiality issues are addressed. Hackathons involving the public release of government datasets for the purpose of solving a problem or addressing an objective are a particularly useful way in which governments can set broad directions for innovation while supporting entrepreneurial networks and the formation of start-ups.

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#### RECOMMENDATION 10.3

The Australian Government should commission a comprehensive and independent inquiry into the Australian innovation system, which is to include among other aspects:

- the business collaboration, intellectual property management and research commercialisation practices of the public sector, including universities and publicly-funded research institutions
- business incubators, accelerators and hubs in universities and publicly-funded research institutions
- the public funding and provision of 'transformative research', including that by universities and publicly-funded research institutions.

#### RECOMMENDATION 10.4

To support access by start-ups and other businesses to publicly-funded data, governments should publicly release their data in formats that ensure privacy and confidentiality requirements are met.

### Access to networks

Successful start-ups are characterised by the strong local networks and connections they form with other parties in local entrepreneurial ecosystems. The local network of a start-up can: provide it with motivation; validate its business ideas; help it identify and secure resources such as partners, suppliers, customers, investors, employees; provide possible new business ideas; and help it move from the business planning phase into the business development phase (OECD and EC 2015).

For example, the Kauffman Foundation noted that:

Research indicates that local connections are far more important to entrepreneurs' success than are national or global contacts because entrepreneurs in the same business environment are the best sources of specific information and knowledge for those starting new businesses and because entrepreneurs need to interact and learn frequently and on an ad-hoc basis for their emerging challenges. While books and courses may inform continuous learning, there is no substitute for advice from local business owners as entrepreneurs navigate the complicated decisions they face at each stage of their businesses' development. Other entrepreneurs can offer the most effective advice that is specific to the new business's situation and location. (Motoyama and Wiens 2015, p. 3)

Similarly, 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)

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However, available data from Comprehensive Australian Study of Entrepreneurial Emergence and Startup Muster indicate that many start-ups in Australia are not part of networks, nor do they form strong connections. Around 90 per cent of ‘nascent and young’ firms are not located in a business incubator (appendix E). Further, 53 per cent of ‘start-ups’ did not have a business mentor; of the 47 per cent who did, 99 per cent thought that having one was useful, although more than half make use of a co-working space (Startup Muster 2015).

While communications technology can enable ‘virtual’ networks and connections, the Commission has been told that face-to-face contact, together with personal introductions and relationships (as distinct from transactions), is still of considerable value to start-ups and investors. As one commentator puts it, ‘the web is swell, but it can feel impersonal’ (Brown 2015).

The potential role for governments hinges on generating network spillovers. To this end, some specific approaches are considered below.

### Business incubators

Australian business incubators (including accelerators, and hubs or co-working spaces) comprise a mix of organisations offering a diversity of services (appendix E).<sup>42</sup> Most are not-for-profit organisations (such as ‘business enterprise centres’) that have been previously supported by, or at least have had strong affiliations with, governments and universities (BIIA, pers. comm 4 May 2015; Kemp 2013; Schaper and Lewer 2009). In recent years, there has been a notable emergence of university and private sector business incubators (box 10.6).

Although networking is among the main reasons why ‘nascent and young’ firms locate in a business incubator, the scope to reduce overhead and other costs associated with setting up a business and to be in a supportive culture are also important (appendix E).

Some commentators and inquiry participants considered that business incubators have beneficial outcomes, particularly in terms of the number of start-ups they have launched as well as other economic effects, such as employment effects, and drew attention to international examples of government support to them (box 10.1). 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), 46 to 69 local jobs were created, roughly 20 times more than created by infrastructure spending. As another example, Business Innovation and Incubation Australia estimated that — based on AusIndustry data

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<sup>42</sup> The Commission uses the term ‘business incubator’ in a broad sense. It notes, however, that many commentators (ATP Innovations 2015; Hub Australia 2014b; Ruehl 2013; Treadgold 2014) distinguish business incubators from accelerators and hubs — see appendix E for details.



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that business incubators graduated 3500 businesses and assuming an annual turnover of \$250 000 per graduate business — business incubators ‘facilitated more than \$875 million in [small to medium enterprise] sales’ (BIIA 2008, p. 5).

**Box 10.6 Some private sector and university business incubators in Australia**

- BlueChilli in Sydney 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.
- The Melbourne Accelerator Program located near and funded by the University of Melbourne aims to support start-ups by their students, staff and alumni by providing \$20 000 in seed funding, office space and mentoring.
- NRMA and Slingshot launched Jumpstart, a new ‘accelerator’ program that seeks to support ‘smart services, connected cars, connected members and member lifestyle start-ups’. 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).

However, others, expressed concerns about the emergence of business incubators in universities and publicly-funded research institutions. Steve Baxter from StartupAUS considered it important not to rely on these institutions to spawn start-ups:

The world has been transformed by innovative business model revolutions, and very few of these have been spearheaded by research-heavy efforts and probably fewer through government-ordained research or higher education institutions. Research is required, and we need to do more of it, but if we believe that we can beat research to death with the stick of government money to try to materialise a business from it then I’m not sure there is any hope. (Sadler 2015)

*Is there a role for governments in assisting business incubators?*

In the past, there was significant Australian Government involvement in business incubators until the closure of its BITS Incubator Program in 2008 and its Building Entrepreneurship in Small Business Program in 2012 (appendix E). However, some

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business incubators continue to be supported by state, territory and local governments particularly through the provision of office space and financial assistance.

The net community-wide benefits of governments supporting business incubators have not always been 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’. The Kauffman Foundation considered that unless a start-up requires capital intensive equipment, the business incubator as a real estate facility does not help entrepreneurs significantly ‘and may only serve to harbor businesses that would not otherwise survive’. Furthermore, it noted that:

Research on the effectiveness of incubators is complicated by the confounding causal issues and problems in identifying control groups for comparison. There is, however, little evidence that incubator firms perform better than non-incubator firms. Of limited research with control groups, Amezcua (2010), for example, demonstrated that incubator firms experienced faster growth in employment and sales, but survive fewer years after graduation than non-incubator startups. (Motoyama and Wiens 2015, p. 2)

Isenberg reported no empirical evidence that a dollar is better spent on ‘an incubating infrastructure or directly on ventures’:

... incubators or innovation centers or clusters or science parks ... are particular support structures that can easily be white elephants, are certainly not necessary, and when they do work, do so only when a) there is first entrepreneurship, and b) they are part of an entire ecosystem. (2011, p. 11)

This uncertainty was apparent in relation to the Australia Government’s BITS Incubator Program. Although the Allen Consulting Group (2003) highlighted positive outcomes in their evaluation of the program, other commentators expressed concern. For example, Lerner (2010, p. 6) considered that the business incubators taking part in the program, ‘frequently captured the lion’s share of the subsidies aimed towards entrepreneurs, by forcing the young firms to purchase their own overpriced services’. Kemp considered that this was one of the factors explaining the demise of the Australian Government’s BITS Incubator Program.

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)

A more optimistic view of the benefits of business incubators was given recently. A report sponsored by Atlassian on the NSW Government’s Australian Technology Park in inner-city Sydney estimated that a ‘successful innovation hub’ would realise \$390 million in economic benefits over 10 years compared with other uses for the site, ‘galvanise technology entrepreneurship and stem the brain drain of successful start-ups and high growth businesses offshore’ (Fitzsimmons 2015). The co-founder of Atlassian, Mike Cannon-Brookes, considered that the reason why the park has not worked to date — some

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of the site remains undeveloped and empty, after office hours — is ‘because no one from the technology industry is there providing leadership’ (Fitzsimmons 2015).

The Commission notes that government involvement in business incubators is not as significant as it once was and is currently very limited. It considers that those business incubators (including accelerators and hubs) that are likely to be successful and enduring will develop and grow organically as a result of particular advantages (such as access to low cost capital, proximity to infrastructure or highly skilled labour, or proximity to a university), regardless of initial funding sources, and are persistent and adaptive. Given the emergence of private sector business incubators, governments should review their support for business incubators against the principles set out in section 10.2.

### Events that bring people together

Business incubators are not the only approach to creating entrepreneurial networks. Another is to hold ‘catalytic’ events that bring entrepreneurs and others together to learn and connect for a particular purpose. As well as hackathons, noted earlier, whose objective is to use data to find a technological solution to a particular problem, another example are events whose purpose is to create a new business.

Although governments have a potential role in enhancing beneficial spillovers from networks, government action with respect to catalytic events need not necessarily follow. There are many examples of events that have been sponsored by the private and not-for-profit sectors, suggesting that government action might not contribute significantly to additional start-up activity from these events, or may even reduce the incidence of non-government organised events.

For example, Startup Weekend is a non-government funded event that has been hosted over 1500 times at over 700 locations involving over 120 000 entrepreneurs globally (Startup Weekend 2015). Over the course of the weekend, people attending present business ideas, form teams, and develop products in order to pitch the newly created businesses to a group of experienced entrepreneurs and investors. The event also connects potential entrepreneurs in the communities who have ideas, but do not yet know how to turn them into viable businesses, to each other and other potential founding team members.

The Commission notes the Kauffman Foundation’s (Motoyama and Wiens 2015) guidelines for governments in relation to networking events. These are that governments:

- avoid creating a formal alliance with various entrepreneurial organisations, as these ‘strict partnerships rarely have a real effect on entrepreneurs’
- avoid providing substantial financial support as networks can be formed without that support, and that ‘government over involvement may actually harm or destroy existing functioning networks’

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- inject a ‘catalytic format’, where rather than hosting receptions simply for the purpose of networking, they hold events with a common objective and content for participants that inspire interaction among them
  - focus events on entrepreneurs’ stages of development, as entrepreneurs find it useful to meet others in the same developmental phase as well as those who are further behind or ahead.

The Commission considers there is likely to be a greater benefit in governments sponsoring hackathons than events that focus on creating start-ups. Hackathons have some attributes that make them well suited to government involvement. They can enable the public release of government data, and allow governments to seek solutions to a problem of community-wide interest.

### Alumni networks

University alumni networks have the potential to foster beneficial linkages between graduates who have become successful entrepreneurs or business people, present students, and academics and researchers. These linkages can result in: access to a source of skilled workers; access to start-up finance; access to business mentoring and advice; and collaboration on research that could result in its commercialisation.

Start-up founders with more links to the alumni of their university are more likely to run successful businesses (Nann et al. 2009). In addition, universities whose alumni experience stronger ‘bonding’ and an ‘in-group feeling’ generate higher economic contributions per start-up founder and are more successful in creating new businesses.

However, commentators and inquiry participants noted that the alumni networks of Australian universities are not as strong or organised as those in other countries. For instance, Universities Australia noted that ‘Australia does not leverage its alumni as well as it could’ (2013, p. 28). Others suggested that a culture of entrepreneurs ‘giving back’ to the university they attended by providing donations or volunteering for mentoring roles is more prevalent in the United States. For example, a survey (The Economist 2015) of around 13 000 students in 100 business schools in various countries found that 9 of the top 10 schools rated by students for the usefulness of their alumni networks were in the United States. Successful entrepreneurs also tend to remain closely connected with their alma mater in the United Kingdom. One such example is Cambridge Enterprise — a seed capital fund formed by the University of Cambridge and supported predominantly by alumni, which aims to commercialise the research of its students and staff (Cambridge Enterprise 2015).

The Commission considers there is scope for Australian universities to review their management of alumni networks with a view to enhancing the benefits that they can bring to entrepreneurial and innovative activity in their local ecosystems.

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#### RECOMMENDATION 10.5

Universities should review their management of alumni networks with a view to maintaining links with alumni and enhancing the contribution of successful entrepreneurs among their alumni back into their universities and local entrepreneurial ecosystems.

### Creating a local consortium

Another approach that governments could take to enabling entrepreneurial networks centres around a group or consortium of local representatives of an entrepreneurial ecosystem. For example, the:

- Canberra Innovation Network was established by the ACT Government, ANU, University of Canberra, NICTA, CSIRO and UNSW (Canberra) to ‘connect innovative businesses and entrepreneurs to what they need to succeed, to promote their success, and to accelerate innovation in the ACT using both tested and experimental approaches’ (ACT Government 2015a). Each of the founding members of the Network agreed to contribute \$50 000 per annum to the Network over five years. The ACT Government’s commitment also includes ongoing financial and other support of more than \$1 million. The Network provides a co-working space, offers business incubator and accelerator programs, and hosts various events that bring entrepreneurs, investors and other people together.
- Massachusetts Institute of Technology Regional Entrepreneurship Acceleration Program (MIT REAP) enables regions (in the United States and other countries) to learn from MIT not only how Boston/Kendall Square works as an entrepreneurial ecosystem, but also how to develop the tools to assess and analyze their own ecosystems, and to design programs and policies to enable their acceleration (Martin Trust Center for MIT Entrepreneurship 2015; Murray and Budden 2014). MIT REAP engages partner regions in four ‘action learning’ cycles over a two year period. Each partner region sends to MIT a team of ‘highly driven and influential members’ representing the region’s stakeholder groups (government, risk capital, academia, entrepreneurs and industry) headed by a ‘regional champion’. Each cycle involves hands-on, interactive 3 day workshops interspersed by action phases. Regional leaders, not MIT, determine what needs to be done and how best to achieve their goals.

The approach of a local consortium applying for or delivering government support has several advantages — it forces the building of a network in order to obtain funding or undertake delivery, is consistent with a holistic approach required of entrepreneurial ecosystems, and can involve people with capacity and motivation to target problems within their ecosystem, and package needed supports.

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Any assistance program giving effect to such an approach would need to be consistent with the principles laid out in section 10.2 — in particular, that it would be: based on an assessment of the potential viability of an ecosystem; time-limited; and involve non-government contributions. Ideally, the consortium would:

- have representatives from universities, businesses, local governments and others local ecosystem participants
- have discretion to determine what measures are needed to support their local ecosystem that meet the program's objective
- specify the in-kind or cash contribution of each representative to the local ecosystem over a specified period.

The program could be piloted in locations where there exists a university or research institution, and a viable local industry or business community.

## **Scale and isolation of Australian markets**

Commentators and inquiry participants argue that the small scale of Australia's markets and Australia's relative isolation from global markets create difficulties for start-ups — in particular: they face difficulties accessing venture capital and skilled workers in Australia; they face a risk averse culture towards entrepreneurs; and the small size of Australia's product markets means they need to focus on global markets or establish a presence overseas if they are to be successful:

... the size of the Australian market and its relative isolation represent one of the biggest challenges related to commercialization [of academic research] efforts — that there are few large corporations to commercialize products with and for, while the population of 25 million is too small to represent a viable domestic market. (Lerner et al. 2014, p. 93)

Australia has a small population and – even in our connected world – it can often feel like the rest of the world is a long way away. We believe this has affected Australia's business culture, with the result that we have been conditioned to take fewer risks since, historically, it has been tough to build a global business from this distance and with a small market as a base. (Pollenizer et al. 2012, p. 2)

### **Is there a role for governments in addressing scale issues?**

Concerns relating to the scale of domestic markets are also held in other small countries such as Chile, Israel, Singapore and New Zealand who have attempted to address them in various ways (box 10.1).

As Jaffe noted, spillovers largely occur more often and at lower marginal cost in 'large agglomerations' of innovators:

So from a policy perspective, agglomeration is still a very real and important phenomenon. And for a small country, it is a very challenging one, because you cannot really create

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agglomeration. New Zealand cannot decide as a matter of public policy that we would like to be as big as Taiwan. You know that's just not an option. So the question becomes: can you do anything to minimise the disadvantages of small scale, or, equivalently, to increase the interactions in a small agglomeration so that it can perform on a level that is closer to larger ones. ... If there is anything policy can do, it would have to affect institutions and modes of interaction among organizations in ways that do, in fact, increase the spillover-bearing interactions. (2015, p. 6)

The Commission considers that governments can best help mitigate scale and isolation issues in Australia by ensuring that the broad economic policy environment is as effective and efficient as possible and by then focusing on barriers to the mobility of capital and people, and the beneficial spillovers from enabling business networks between Australia and overseas. As noted, while communications technology can enable 'virtual' connections between Australian and overseas entrepreneurs and investors, face-to-face contact is still of considerable value.

Some measures discussed above can also be used to generate better networks. For example, governments releasing their data as part of a catalytic event can be beneficial in attracting foreign entrepreneurs, investors and other relevant parties to Australia. Another approach is the establishment of overseas contact points for Australian entrepreneurs to network into other countries — such as *Advance* (2015), which is an Australian Government and private sector partnership that creates a 'global community' of Australians, including Australian university alumni. Indeed, Lerner et al. refers to the creation of real and virtual 'launching pads' in Silicon Valley and 'innovation hotspots' and other bridge building measures between domestic and foreign entrepreneurs (Lerner et al. 2014, p. 104).

However, any use of 'trade missions' to successful overseas entrepreneurial ecosystems would need to be consistent with the principles laid out in section 10.2 particularly that it is time-limited and does not swamp or displace existing private sector activity.

### **Administrative burdens associated with seeking assistance**

Some commentators and inquiry participants have noted the relative 'under-exploitation' of government support by start-ups. For example, Pollenizer et al. estimated that 39 per cent of Australian start-ups have accessed grants (2012). CAUSEE data show that only around 9 per cent nascent and new businesses received some form of government support (appendix E).

There has also been criticism about the red tape in applying for 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.

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As noted earlier, the Commission considers that existing assistance programs for the set-up of businesses should be reviewed by all levels of government against the principles set out in section 10.2; those that do not meet those principles should be concluded within three years. Where governments decide to provide support, they should ensure that the burdens associated with meeting administrative requirements are as limited as possible while addressing accountability concerns (for example, as to the probity of applicants seeking assistance). Given that taxpayer funds are involved, the Commission considers that it is appropriate and reasonable for businesses, in seeking assistance, to fill out some paper work, particularly to ensure that data are collected to enable program evaluation. It notes that solutions to address compliance burdens imposed by government procurement processes on businesses involving simplified forms for small businesses and electronic lodgement could also apply in respect of assistance applications.



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# 11 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.
- Government assistance to facilitate structural adjustment can deter inefficient businesses from exiting. Structural adjustment assistance should reflect appropriate design features including that it: targets justifiable objectives; facilitates adjustment, not prevent or obstruct it; and be limited in regard to time.
- Beyond raising the importance of exit planning and the continued provision of high quality, accessible information on relevant regulatory issues, there is no role for governments in business exit planning.

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The outflow of businesses from the Australian economy — business exits — comprise changes in ownership (temporary exits whereby businesses are sold, taken over or merged) and cessations (permanent exits where businesses stop operation altogether). A small proportion of cessations involve business related bankruptcy or insolvency and these are discussed in chapters 12 to 15. This chapter discusses the vast majority of business exits, those which are ‘voluntary’.

The efficiency of voluntary exit is an important policy consideration. In particular, unnecessary regulatory burdens and barriers to voluntary exit may hinder the efficient operation of markets by delaying the use of business assets (or income derived from them) for alternative activities such as retirement or a new business venture (chapter 2).

## 11.1 How and why do businesses exit?

Voluntary business exit includes ‘successful’ exits — selling the business for profit either through a trade sale or listing on the stock market, or merging with another business to enable new opportunities and growth. For example, a start-up such as a biotechnology business may accept an opportunity from a buyer who sees strategic value in acquiring the business, prior to the final development and testing of the product.

Voluntary exit also includes businesses that are sold because of poor market performance and financial difficulties (but not yet failure). While financial considerations are often an important factor, the decision for a business to voluntarily exit does not always relate to financial performance. Many businesses exit for ‘lifestyle’ reasons — for example, when the owner retires, relocates, or seeks different opportunities. In fact, there are many reasons why businesses exit, including:

- retirement
- an opportunity for a merger which may provide 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
- listing the business on the share market is viewed as the next logical step to achieve business growth
- an opportunity for a start-up to sell the business ‘idea’ to an established business.

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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 are summarised in box 11.1.

The exit pathway chosen by a business depends on a number of factors including the ownership and management structure (chapter 3), the value of the business, its potential for growth and characteristics of the owner (such as age). The exit pathway has implications for future business activity — whether business operations continue, in what form and how it is managed.

### **Box 11.1 Pathways for voluntary exits**

#### **Family succession**

The business is transferred to the next generation of family members. Realisation of the wealth in the business to generate retirement income, business continuity and achieving family harmony are the key targeted outcomes of succession. Succession methods include trust arrangements, establishment of the business as a company, business sale to successors or gifting the business to successors. The management and choice of succession arrangements is influenced by a family's personal, social and business values.

#### **Trade sale (acquisition)**

The business (or part of it) is sold to a competitor, supplier or customer. A trade sale also includes start-ups where the asset valued by the acquirer is typically an 'idea' rather than an operating, profitable business. The acquiring business may or may not make substantial changes to the business and its management.

#### **Merger**

A merger involves the owners of two businesses becoming the owners of a new merged business. Common reasons for merger include: to increase market share; business diversification; improve efficiency and productivity; and to reduce tax and transactions costs such as marketing expenses. Mergers can take three forms — horizontal, vertical and conglomerate.

- Horizontal mergers occur between businesses that supply a similar or substitutable good or service.
- 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. Forward integration refers to a business merging with part of its distribution chain.
- Conglomerate mergers are mergers of 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.

(continued next page)

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## Box 11.1 (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 3) 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, p. 1)

### **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 business 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 typically used only by growth businesses with high performance goals. While an IPO can provide benefits such as a large and diversified equity base they 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 non-employee shareholders (chapter 3).

### **Cessation and voluntary liquidation**

Cessation and liquidation involves winding up the business by selling its assets, paying outstanding debts and distributing any surplus to the business owners. This is a relatively 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 (typically attributed to the owner) in the business is lost. Cessation often occurs when the business is generating little income or when there is not an obvious buyer (often due to location — such as regional or remote areas or a lack of market-related knowledge or skills).

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## 11.2 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 business exits can be extrapolated for data on bankruptcy or liquidation (chapters 12 to 15). These reveal that approximately 6 per cent of business exits are a result of formal insolvency (chapter 2).

Similarly, data from the Comprehensive Australian Study of Entrepreneurial Emergence, indicated low rates of insolvency and bankruptcy among nascent and young firms. Results from the survey include:

- 66 per cent of survey respondents from terminated businesses stated that the business did not lose any money
- 34 per cent of respondents from terminated businesses reported that the owners lost money
- 3 per cent of respondents from terminated businesses reported that non-owner stakeholders (such as banks, suppliers, customers, employees and family or friends) had lost money.

Unfortunately, broader data on how and why businesses exit are patchy. Surveys on the exit options being considered by family businesses have mixed results.

- 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 or that more family businesses have been struggling to involve the next generation in the family business. The PwC 2014 survey also 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 an initial public offering (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 to pass management and ownership of the business to the next generation (table 11.1).

**Table 11.1 Exit pathways and timeframe of exit for family businesses**  
Family Business Survey 2013

Exit strategy	Exit timeframe of businesses considering the exit strategy			
	Businesses considering strategy	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

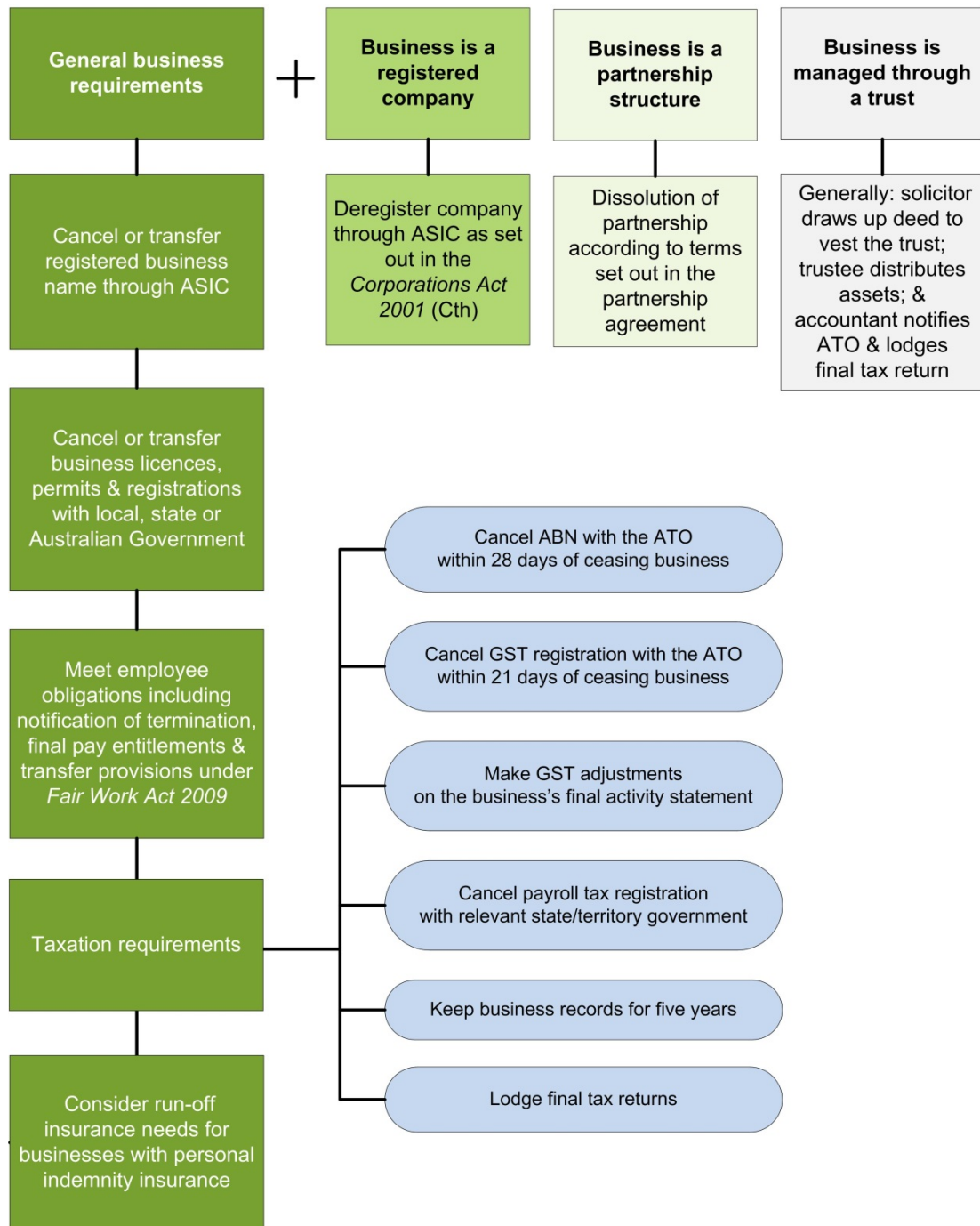
Source: KPMG and Family Business Australia (2013)

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 only around 40 per cent of businesses listed by a business broker will be sold and the remainder are closed.

### 11.3 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 11.1.

Figure 11.1 Business exit requirements



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Stakeholders noted that the complexity and time it takes a business to exit is directly related to the size, structure and specific circumstances of the business. A sole trader operating from home may take a couple of weeks to close down, but larger companies with complex operations may take several years to deregister (Queensland Government 2015d). Box 11.2 summarises the procedures required to deregister a company.

### Box 11.2     **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:

- 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 declaration that the company will be able to pay its debts in full within 12 months from the commencement of the winding-up.

A liquidator is appointed by members of the company to manage the day-to-day running of the company and the liquidation process. The company then passes a special resolution that the company be wound up voluntarily. All members (as defined under section 231 of the *Corporations Act 2001* (Cth)) 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 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. The company is deregistered 3 months after the final form is lodged.

*Source:* ASIC (2015c)

Small business stakeholders commented that some small businesses may struggle with the cumulative burden of requirements to transfer or close a business. 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 11.4 discusses the role of governments in providing guidance on business exit.



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## 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 11.3). 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 11.3      **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 noted 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)

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The performance of the Workplace Relations Framework including the Fair Work Act is the focus of a separate inquiry by the Productivity Commission. The Commission's draft inquiry report (on the Workplace Relations Framework) explored a number of concerns related to the transfer of business provisions and recommended:

The Australian Government should amend the Fair Work Act 2009 (Cth) so that an employee's terms and conditions of employment would not transfer to their new employment when the change was at his or her own instigation. (PC 2015, p. 759)

The Commission's final report will be completed by the end of 2015.

### **The tax treatment of losses under the same business test**

Chapter 3 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 the 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. However, it will not satisfy the SBT if it derives accessible income from:

- a type of business of a kind that it did not carry on before the test time (new business test)
- a transaction of a kind that it had not previously entered into in the course of its business before the test time (new transaction test) (ATO 2013b).

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 a recent discussion paper on the Reform of Australia's Tax System (The Treasury 2015c) 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 improve the operations of underperforming firms. In many cases consumers or suppliers benefit from mergers. However, some mergers and acquisitions may give rise to a concentration of market power

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which can have negative implications for the market, suppliers and consumers. As a result, notwithstanding any gains in productive efficiency, society may be worse off if reduced competition leads to excessive prices and/or reduced quality and choice.

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:

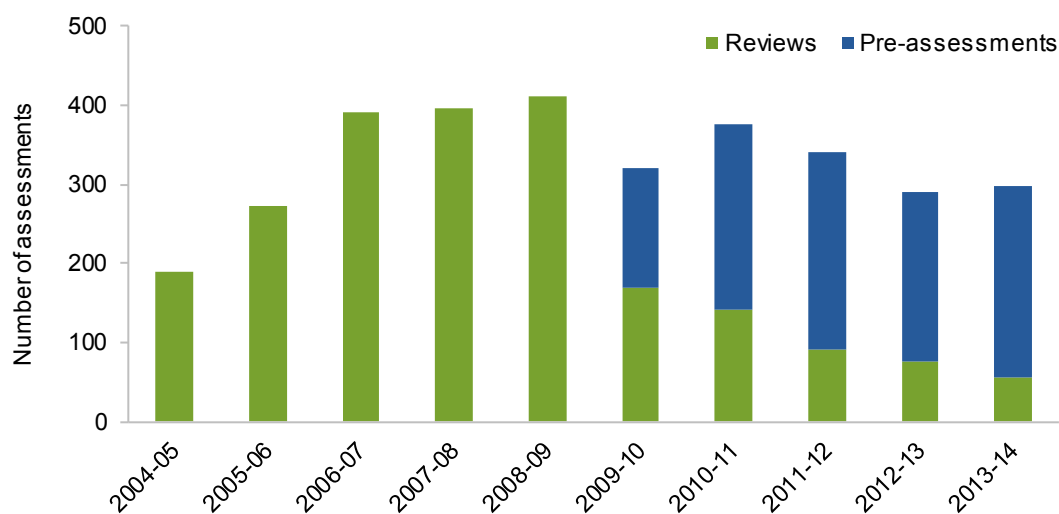
- the actual and potential level of import competition in the market
- the extent of barriers to entry to the market
- the level of concentration in the market
- the degree of countervailing power in the market
- the likelihood that the acquisition would result in the acquirer being able to significantly 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 (ACCC 2008).

### How many businesses are assessed for merger or acquisition?

Each merger or 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 11.2). Of the mergers and acquisitions reviewed each year, the majority are not opposed by the ACCC (table 11.2).

Figure 11.2 ACCC assessments of mergers and acquisitions<sup>a</sup>



<sup>a</sup> Matters which were cleared through a preliminary assessment and those which were subject to a review were not distinguished prior to 2009-10.

Source: Data provided by the ACCC

Table 11.2 Outcomes of ACCC assessments of mergers and acquisitions

	Publicly opposed <sup>a</sup>	Confidential concern <sup>b</sup>	Under-taking <sup>c</sup>	Not opposed <sup>d</sup>	With-drawn <sup>e</sup>	Variation <sup>f</sup>	Total reviews	Pre-assessed <sup>g</sup>	Total matters
2004-05	2		9	178			189		189
2005-06	0	3	8	235	26		272		272
2006-07	6	11	8	335	25	5	390		390
2007-08	5	6	6	353	23	4	397		397
2008-09	1	9	5	371	26		412		412
2009-10	8	6	4	131	16	3	168	153	321
2010-11	3	4	7	110	14	3	141	236	377
2011-12	1	6	3	60	17	3	90	250	340
2012-13	6	5	2	55	4	4	76	213	289
2013-14	4	2	10	36	2	1	55	242	297

<sup>a</sup> If a public review concluded that a merger or acquisition does, or may substantially, lessen competition, then the ACCC would publicly oppose it. <sup>b</sup> If a confidential review concluded that a merger or acquisition does, or may substantially lessen, competition, then the ACCC advises the parties of its concerns and would conduct a public review should the merger parties wish to proceed with the transaction. <sup>c</sup> 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. <sup>d</sup> If the ACCC concludes that the merger or acquisition is not likely to substantially lessen competition, then it does not oppose the transaction. <sup>e</sup> 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. <sup>f</sup> 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. <sup>g</sup> Preliminary assessments were not distinguished prior to 2009-10.

Source: Data provided by the ACCC

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## 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. The review did, however, recommend a number of changes to merger approval processes (box 11.4). In line with the Harper Review the Commission supports more streamlined merger assessment processes.

### RECOMMENDATION 11.1

In line with recommendations from the Harper Review, the Australian Competition and Consumer Commission should combine the formal merger clearance process and the merger authorisation process, and remove unnecessary restrictions and requirements to improve the efficiency and effectiveness of business transfer processes.

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## Box 11.4 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 [recommended] Australian Council for Competition Policy.

*Source:* Harper et al. (2015, p. 67)

## 11.4 Issues in voluntary exit

Inquiry participants raised four 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
- that government assistance to facilitate structural adjustment can delay or deter the exit of inefficient businesses.
- the challenge for business in transitioning through demographic change
- 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. Capital gains tax (CGT)

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considerations have been raised as a key concern for businesses, and in particular, for small and family businesses.

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. 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).

The rationale behind the concessions is to provide small business greater access to additional funds to grow their business or to provide for retirement. Box 11.5 summarises the small business CGT concessions.

#### **Box 11.5 Small business capital gains tax concessions**

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 a \$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 2015c).

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, calculated 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 and \$160 million for the 15 year exemption (The Treasury 2015c).

Generally, the small business CGT concessions are viewed by stakeholders as generous. 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.

Table 11.3 highlights the different treatment of CGT concessions across business structures (submitted by CPA Australia) and box 11.6 presents the key concerns raised by stakeholders.

**Table 11.3 Access to CGT concessions by business structure**

	<i>CGT discount</i>	<i>Active asset reduction</i>	<i>Active asset retirement</i>	<i>Active asset rollover</i>	<i>Active asset 15 year exemption</i>
<b>Individual<sup>a</sup></b>					
Selling a business	✓	✓	✓	✓	✓
Selling a share in a company	✓	✓	✓	✓	✓
Selling an interest in a trust	✓	✓	✓	✓	✓
<b>Trusts</b>					
Selling a business	✓	✓	<b>b</b>	✓	<b>b</b>
Selling a share in a company	✓	<b>c</b>	<b>c</b>	<b>c</b>	<b>c</b>
Selling an interest in a trust	✓	<b>c</b>	<b>c</b>	<b>c</b>	<b>c</b>
<b>Company</b>					
Selling a business	<b>x</b>	<b>d</b>	<b>b</b>	✓	<b>b</b>
Selling a share in a company	<b>x</b>	<b>e</b>	<b>e</b>	<b>e</b>	<b>e</b>
Selling an interest in a trust	<b>x</b>	<b>e</b>	<b>e</b>	<b>e</b>	<b>e</b>
<b>Superannuation fund<sup>f</sup></b>					
Selling a business	✓	<b>x</b>	<b>x</b>	<b>x</b>	<b>x</b>
Selling a share in a company	✓	<b>x</b>	<b>x</b>	<b>x</b>	<b>x</b>
Selling an interest in a trust	✓	<b>x</b>	<b>x</b>	<b>x</b>	<b>x</b>

<sup>a</sup> Partnership CGT assets are treated the same as if the individual held the assets. <sup>b</sup> 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 who also holds an interest in the company or the trust. <sup>c</sup> In order for a trust to access the concessions there must be a beneficiary of the trust who is a significant individual in the company or trust in which the investment is held and that individual and other CGT concession stakeholders must have a combined participation percentage of at least 90 per cent. <sup>d</sup> To receive this concession the capital gain must be paid out on liquidation of the company. <sup>e</sup> In order for a company to access the concessions there must be a shareholder of the company who is a significant individual in the company or trust in which the investment is held and that individual and other CGT concession stakeholders must have a combined participation percentage of at least 90 per cent. <sup>f</sup> 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)



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## Box 11.6      **Comments about capital gains tax concessions**

The Institute of Public Accountants, Australian Small Business White Paper Summit:

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)

Kohler, in an article for the *Business Spectator*:

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 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 that 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)

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## Reviews of small business taxation

Issues raised by participants to this inquiry are not new and have been raised in a number of reviews, including the 2010 Henry review on Australia's Future Tax System. That review recommended rationalising and streamlining the current small business CGT 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)

More recently, CGT arrangements 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 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 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 to 'better target the concessions and to eliminate the disincentives and unfairness associated with the current rules' (Board of Taxation 2014, p. 68).

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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 2015c, 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.

Reform of CGT concessions must consider the fundamental (inverse) relationship between CGT and retirement income for small business owners. CGT can undermine the ability of a business owner to use their business as a store of funds for retirement and in turn increase reliance on government funded pensions. Small business CGT concessions provide recognition that small businesses often need to reinvest earnings into their businesses without being able to contribute to superannuation on a regular basis. For many small businesses, and in particular the self-employed, their business is effectively their 'superannuation'. The White Paper on the Reform of Australia's Tax System should evaluate options (such as increasing or removing the superannuation lifetime limit under the retirement exemption) to improve the effectiveness of small business CGT concessions by allowing small business owners to contribute to their retirement using their accumulated capital gains.

#### RECOMMENDATION 11.2

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 relationship between small business capital gains tax relief and retirement incomes policy for small business owners.

### **Structural adjustment assistance**

Governments provide assistance to individuals and businesses to help them adjust to structural changes in the economy (including changes resulting from government reform measures). Examples include the: Australian Government's Remote Jobs and Communities Business Adjustment Package, Manufacturing Transition Programme, and Automotive Diversification Programme; Queensland Government's Drought Relief Assistance Scheme; and Western Australian Government's Industry Facilitation and Support Program (West Pilbara Round).

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Structural adjustment assistance generally seeks to help a region, community or group of workers cope with an adverse event but it can create barriers to the set-up, transfer and closure of businesses. It can discourage the exit of unprofitable businesses and the entry of new profitable businesses — both outcomes being inefficient from a community-wide perspective. For example, in its study on drought support, the Commission found that the assistance: was overwhelmingly targeted at maintaining farming operations during a drought; discouraged preparedness or incentives for longer term self-reliance; and was not an effective means of assisting drought-affected farmers to exit the industry (PC 2009c).

A number of inquiry participants expressed concern that structural assistance was often directed to industries on the verge of closure and as a result inhibited efficient business exit. For example, Master Electricians Australia stated:

Government programs and subsidies can act as a barrier to the closure of businesses by allowing unprofitable and failing businesses to remain operational.

A relevant example of this situation concerns the Home Insulation Program (HIP). The introduction of the HIP in 2009 as part of the Federal Government's Energy Efficient Homes Package. The final report from the Royal Commission into the HIP stated that the number of insulation installation businesses operating increased from approximately 200 prior to the HIP to 8359 registered businesses after the program was introduced. Many of these would have been pre-existing businesses who decided to begin offering insulation installation solely because of the significant increase in demand flowing on from the Energy Efficient Homes Package. It is also not unlikely that some of these businesses were being kept in operation based largely on the revenue they were receiving from insulation installation. (sub. 6, p. 3)

The Business Council of Australia (sub. 29) advised that structural adjustment assistance should only be provided on a short-term basis and reviewed in order to prevent barriers to business set-up, transfer and closure.

The Commission's general view of structural adjustment assistance (for example, Banks 2011; PC 2009c, 2012b, 2013b, 2014b) is that, if it is provided, it should reflect appropriate design features including that it: targets justifiable objectives; facilitates adjustment, and not prevent or obstruct it; and be limited in regard to time. To do otherwise would simply 'divert pressures' onto other parts of the community and economy (Banks 2011).

## **The ageing of business owners**

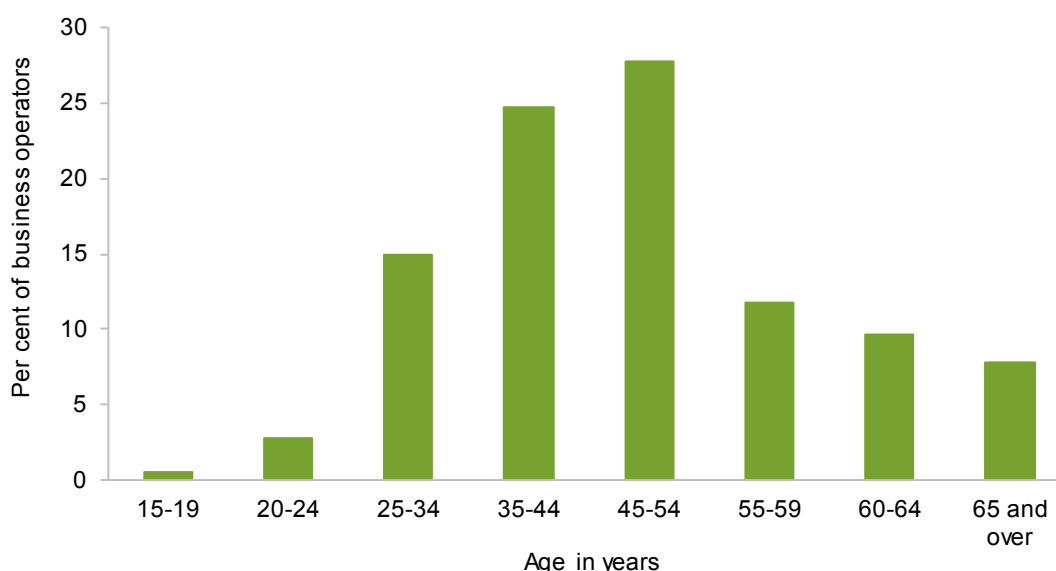
The ageing of business owners over the next decade is expected to coincide with an increase in the number of owners seeking to retire and exit their business, thereby bringing to a head the challenge of passing on businesses to the next set of owners and realising the value of the business and underlying assets. GRG Momentum commented:

While time will tell exactly how the baby boomer business exit tsunami unfolds, we believe it will have the following key features:

- As baby boomer business owners reach retirement age they will look to sell their business or pass it on to family leading to much higher numbers of businesses hitting the market place than usual in a relatively short period of time.
- The number of businesses passed on to the next generation has been steadily declining for some time. Fewer children are interested in taking over family businesses. From our experience, children who are entrepreneurially minded often prefer to start their own business.
- The flow on consequence from the above is more buyers will be required to buy the increased number of businesses available for purchase. We believe it's unlikely there will be sufficient buyers at various time to satisfy the likely selling demand.
- As a result, many private business owners will be faced with the prospect of selling their business for a substantially lower amount than they want or, in many cases, won't be able to sell their business at all. (sub. DR61, p. 7)

The ABS *Counts of Business Operators Survey* found that in 2012 the greatest percentage of business operators were in the 45–54 years age group (28 per cent) and the majority (57 per cent) were aged over 45 years (figure 11.3). 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 11.3 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,

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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. For example, GRG Momentum said that economic consequences may include:

- job losses
- a lessening of competition in various markets
- the loss of innovation associated with failed or closed businesses
- the inability of many private business owners to adequately fund their retirements (which will effectively move this financial burden back to government)
- the removal of key services in some sectors such as professional advisory and health services (where a disproportionately high level of baby boomers tend to own most of the smaller businesses) and in rural and regional areas. (sub. DR61, p. 7)

However, it is difficult to predict the magnitude and duration of any impacts. Labour displaced by structural change may be employed elsewhere or retrained in more productive occupations while any impact on competition is likely to be short term and highly localised.

The ageing of business owners is likely to have broader impacts, particularly in relation to taxation and retirement income policy. In the context of this inquiry the Commission has sought to address barriers to the set-up, transfer and closure of businesses to improve the efficiency and effectiveness of the market for businesses which will in turn improve the ability of business to transition through demographic change.

## **Succession planning**

The importance of exit planning has received increasing attention in the context of ageing business owners. An exit plan identifies business specific circumstances and priorities, 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. PwC stated:

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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 2015c)

## Family business succession

For the majority of family businesses exit planning is about preparing the next generation of the family for succession. The 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).

Succession planning for family businesses is about ensuring the ongoing success of a business through a strategically timed transfer of ownership and control (and the capacity to provide employment and income opportunities for future generations). In addition to financial and legal considerations, succession planning 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. This is particularly important to manage the process of generational change in family business.

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)

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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 11.7).

For many, 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)

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) there is a risk that decades of business experience may be lost. For example:

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)



## Box 11.7 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.

For example, the 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)

<i>Issue</i>	<i>Identified as important</i>
	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)

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And a further risk is that poor planning may lead to economic decline.

This [the 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)

## The role of government and business advisors

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 business (and in particular small business) requires 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)

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 (2015c) 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
- the Australian Taxation Office (2015a) website provides a factsheet on tax issues to consider when planning for business exit
- the Queensland Government (2015a) *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
- similarly, the Government of Western Australia, Small Business Development Corporation (2015) website provides guidance material on closing or winding up a business, selling a business, selling a franchise and succession planning.

While governments are best placed to provide general advice on the legal and regulatory requirements of exit, planning for business exit is largely a commercial matter that each business needs to consider given the business and the owners individual economic circumstances. Seeking professional advice is a vital part of any business and exit is no exception. Relevant advisors include accountants, financial advisors and planners, solicitors, business bankers, insurance brokers, business brokers and industry organisations. Business advisors are best placed to value a particular business, understand

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the relevant regulatory and tax requirements, the markets in which that business operates and to assess the future financial needs of the exiting business owner.

Business owners who are not proactive in seeking quality information and advice are less likely to achieve a successful exit. Thus, it is in their best interest to do so. In the Commission's view, it is highly unlikely that broad-based government programs could be a substitute for this and, indeed, may cause more harm than good. Beyond raising awareness of the need to plan, and providing good regulatory advice, the Commission sees no role for governments in the planning of individual business exits.

**RECOMMENDATION 11.3**

Governments should confine their involvement in business succession planning to raising the importance of this issue publicly, ensuring the provision of high quality, accessible information on relevant regulatory issues, and ensuring government processes are as timely and inexpensive as possible with appropriate cost recovery.



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## 12 Personal insolvency

### Key points

- Sole traders, individual members of a partnership, non-corporate trustees, individuals who personally guarantee business debts, and shareholders in companies with unlimited liability can be made personally insolvent through the failure of a business. Business-related bankruptcy is responsible for approximately 20 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 (for bankruptcy) or the business (in the case of bankruptcy, PIAs or debt agreements).
  - PIAs and debt agreements are essentially forms of personal financial restructuring. Their use is increasing, but bankruptcy is still the dominant personal insolvency process.
- While there are prima facie arguments for the consolidation of the regulation of personal and corporate insolvency within a single body, the Commission considers that given the likely high administrative costs of doing so, 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.
  - The obligation of bankrupts to make excess income contributions to trustees should remain for three years, and possibly longer if the period of bankruptcy is extended.

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 business people, 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.

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## 12.1 Characteristics and trends in personal insolvency

During 2014-15, there were over 28 000 personal insolvencies recorded in Australia (AFSA 2014f). These insolvencies can be characterised in a number of ways, including the time and costs involved, the value of assets and liabilities, and most pertinent to this inquiry, whether they were business-related.

Compared to other jurisdictions with similar insolvency laws, Australia has the lowest number of personal insolvencies per capita (0.1 per cent), followed by New Zealand (0.2 per cent), England and Wales (0.2 per cent), Canada (0.4 per cent), and the United States (0.5 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.

### Business-related and non-business related personal insolvencies

Sole traders, individual members of a partnership, non-corporate trustees, individual guarantors of business debts, and shareholders in companies with unlimited liability can become insolvent through being personally liable for debts incurred by a business in which they have an ownership stake. As identified in chapter 3, of these, a sole trader is the most common structure used in Australia under which individuals may be personally liable for debts. There were over 555 000 sole traders in Australia as of 2013-14, representing approximately 26 per cent of all businesses (ABS 2015d). Sole traders are not legally distinct from their business and individual owners will therefore be responsible for financing any debts or losses incurred by the business. As a result, when a sole trader business fails an individual may become personally insolvent.

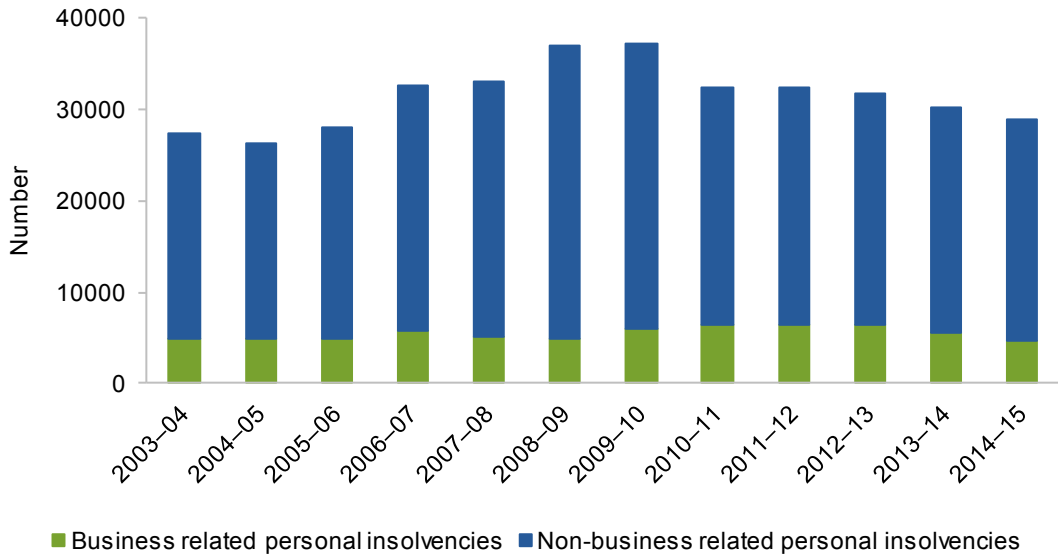
A business-related personal insolvency occurs where an individual's bankruptcy, debt agreement or personal insolvency agreement is directly related to his or her proprietary interest in a business (AFSA 2015a). While non-business related bankruptcies relating to consumer unemployment, income and use 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 12.1).

From 2003-04 to 2014-15, business-related personal insolvencies occurred at a relatively consistent rate, reaching a low of around 4700 in 2014-15 and a peak of about 6400 in 2012-13. 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. On average, non-business related personal insolvencies were around five times more common throughout this period than business-related personal insolvencies.

The occurrence of business-related personal insolvencies varies across occupations. Technicians and trades workers (including construction trades workers) represented the highest number of debtors entering a business-related personal insolvency in 2013-14,

followed by machinery operators and drivers, labourers, and managers (figure 12.2). 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 was ‘economic conditions’ (figure 12.3).

**Figure 12.1 Business and non-business related personal insolvencies**



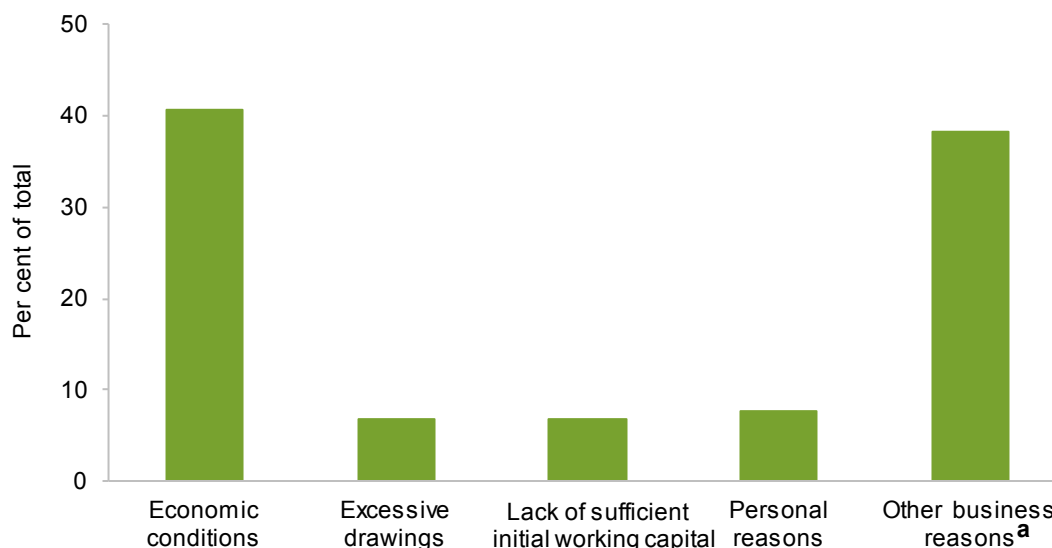
Source: AFSA (2015f)

**Figure 12.2 Business-related personal insolvencies by occupation**  
2013-14



Source: AFSA (2014e)

**Figure 12.3 Causes of business-related personal insolvencies**  
2013-14



<sup>a</sup> Other includes excessive interest, failure to keep proper books, gambling or speculation, inability to collect debts, lack of business ability, seasonal conditions and other business reasons.

Source: AFSA (2014b)

## Time and cost of personal insolvency regimes

There is a lack of data regarding the average costs incurred by individuals undertaking each personal insolvency 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 (supervising 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.’



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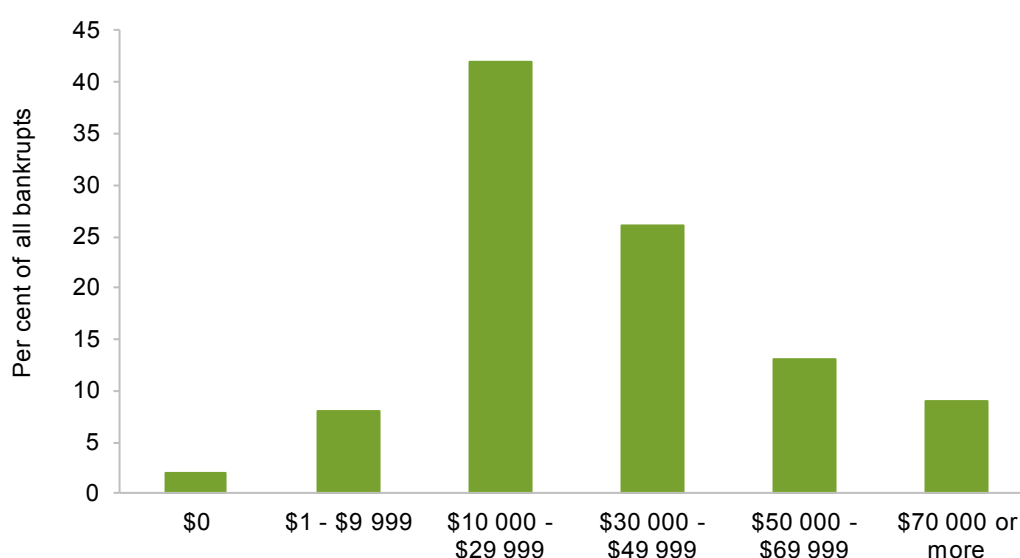
These figures suggest that the time and costs associated with undertaking any personal insolvency administration are reasonable. However, caution must be taken when analysing data based on complaints. Complaints processes can be prescriptive, and it is difficult to judge whether the number of complaints 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 12.4). 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.

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Figure 12.4 **Income earned by bankrupts in the 12 months prior to bankruptcy**  
2011



Source: ITSA (2012)

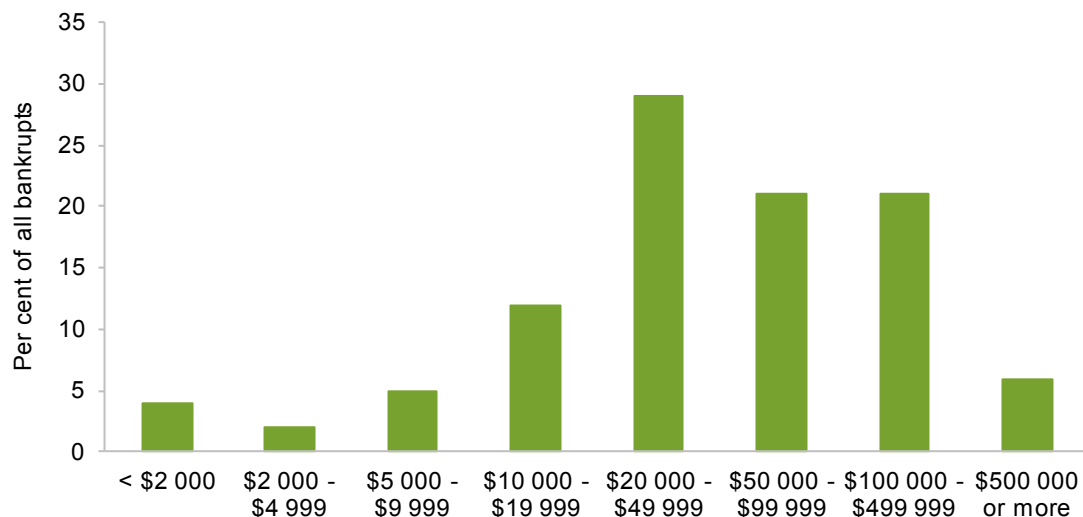
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The unsecured debt level of bankrupts can be used to indicate the average value of liabilities owed by debtors (figure 12.5). Despite average incomes of bankrupt debtors

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).<sup>43</sup> There is no information on how unsecured debts might vary between business-related and other bankruptcies.

The fact that most bankrupts possess unsecured debts exceeding their annual income suggests that losses faced by creditors who provided the funding to the debtors are likely to be, on the whole, high. Personal insolvencies can affect a wide range of parties beyond the debtors. Given the number of personal insolvencies undertaken each year (nearly 30 000), this underscores the importance of an efficient and effective legal framework for resolving them.

**Figure 12.5 Unsecured debt level of bankrupts**  
2011



Source: ITSA (2012)

<sup>43</sup> Unsecured liabilities relating to 'House Mortgage' refer to debts where the amount owing exceeds the value of the security (ITSA 2012). The greatest liabilities were represented in the 'other' category (47%). However, differences in debtors' responses including debtors leaving the nature of the debt field blank or differing in the categories they assigned to debts may have affected the data (ITSA 2012).

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Data provided by AFSA indicate the average rates of return to creditors are low. For business-related bankruptcies discharged in 2014-15, creditors received an average rate of return of 1.7 cents per dollar. Rates of return were similar for non-business related bankruptcies (2.2 cents per dollar) over the period. In business and non-business related personal insolvency agreements, creditors received an average of 1.1 and 5.3 cents per dollar respectively. Returns to secured creditors were higher than returns to unsecured creditors from bankruptcies (4.8 compared to 0.9 cents per dollar) and lower in the case of personal insolvency agreements (0.7 compared to 2.9 cents per dollar). Rates of return are significantly higher for debt agreements, with creditors receiving 58.9 cents per dollar for agreements completed in 2013-14 (AFSA 2014g).

## 12.2 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<sup>44</sup> under the *Bankruptcy Act 1966* (Cth) (Bankruptcy Act).

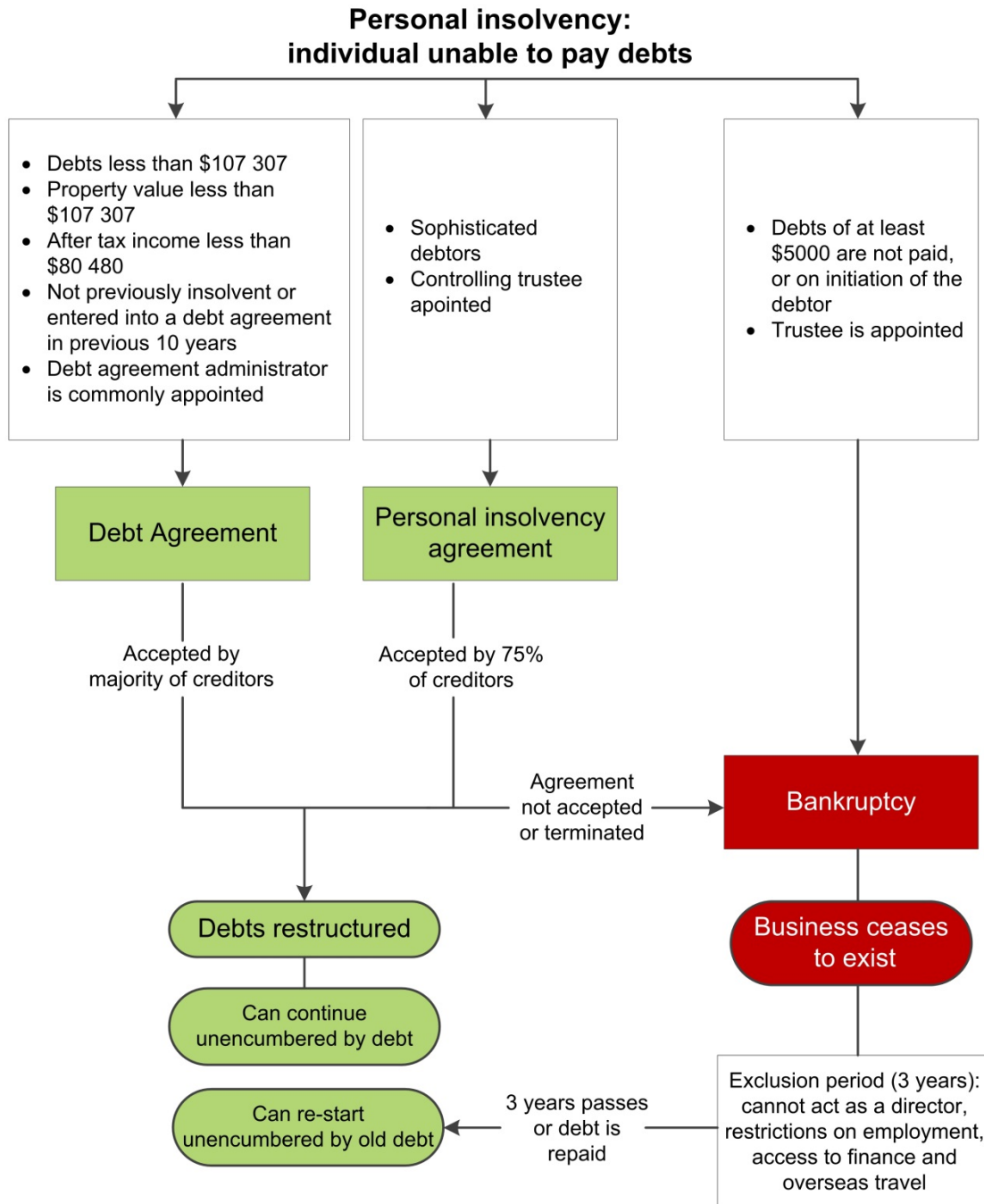
Under the Bankruptcy Act, there are three main insolvency administrations available to individuals, each with their own distinct characteristics. These are bankruptcy, Personal Insolvency Agreements (PIAs) and debt agreements. Debt agreements and PIAs are relatively new options for dealing with personal 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. The criteria for each type of personal insolvency administration, and their interaction with each other, are depicted in figure 12.6.

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, and place restrictions on the individual that can hinder their ability to start another business.

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<sup>44</sup> 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 12.6 Options for personal insolvency and restructuring



Not all paths are mutually exclusive

Green: Business may still trade

Red: Business cannot trade

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## 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<sup>45</sup> through the Australian Financial Security Authority (AFSA). In this instance, the debtor must also lodge a statement of affairs.<sup>46</sup> Alternatively, a creditor may take action to have an individual declared bankrupt by order of the court, under a sequestration order.<sup>47</sup> 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<sup>48</sup> 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 12.1). Together, these

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<sup>45</sup> 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 through the issue of statutory notices (AFSA 2015d).

<sup>46</sup> 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).

<sup>47</sup> 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).

<sup>48</sup> Divisible property is property which can legally be sold in bankruptcy by the trustee (AFSA 2015d).

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restrictions can impose burdens on those seeking to re-start a business (or simply in employment) by, for example, unduly limiting legitimate overseas travel or increasing the difficulty to access capital due to records of debt history. Some of these elements are a deliberate outcome of the design of current bankruptcy policy, but can nevertheless create an obstacle to the set-up of new businesses.

A bankrupt 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 12.1      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.

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 \$5447 in July 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.

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 Corporations Act also prohibits debtors from acting as the director or manager of a corporation during the bankruptcy period.

Bankruptcy can end through either 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. Grounds for objection are stipulated in section 149D of the Act, and include engaging in misleading conduct, as well as failing to: provide relevant property and

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income details, pay compulsory income contributions, or disclose a liability that existed before the bankruptcy period.

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**

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:

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- 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<sup>49</sup>
- 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.

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<sup>49</sup> Figures were released 20 March 2015. They are indexed for inflation and updated twice a year by AFSA.



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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 creditors' 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<sup>50</sup> after meeting all obligations of the agreement.

## **Use of bankruptcy, PIAs and debt agreements**

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.

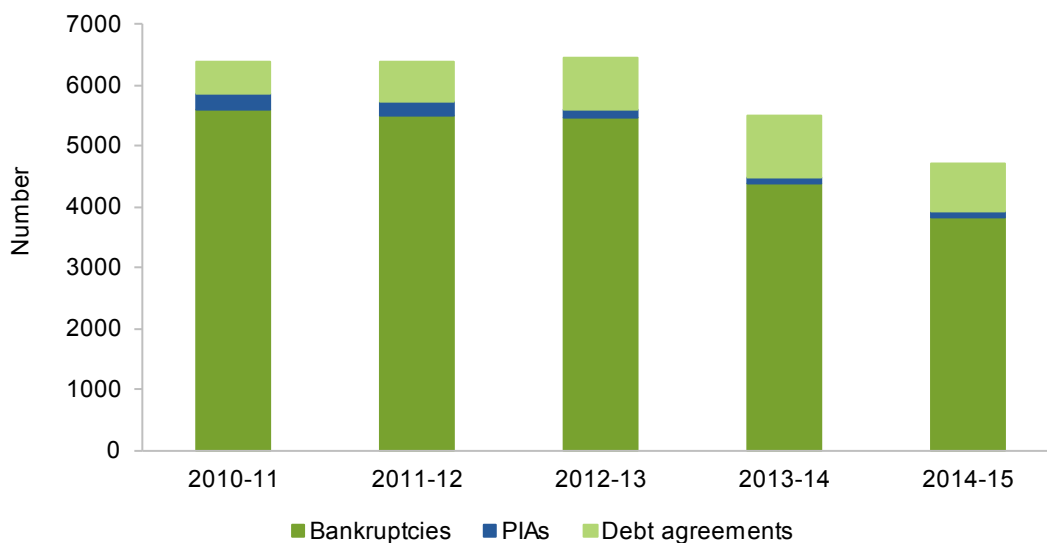
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<sup>50</sup> When a debt agreement ends under subsection (1), the debtor is entitled to any property that was subject to the debt agreement but was not required by the agreement to be distributed to creditors (s 185n).

- 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.

Despite these advantages, bankruptcy remains the most commonly used method for dealing with personal insolvency in Australia. Of the 28 000 personal insolvencies in 2014-15, bankruptcies were the most commonly utilised form (17 163), followed by debt agreements (10 911) and PIAs (214) (AFSA 2014f). 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. These trends suggest that the agreement alternatives to bankruptcy may have been underutilised previously, but are becoming more popular. Specifically regarding business-related personal insolvency, bankruptcies represent a greater proportion of all cases (relative to PIAs and debt agreements), however they have also declined in popularity in recent years (figure 12.7).

Figure 12.7 **Business-related personal insolvency regimes in Australia**



Source: AFSA (2015g)

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 12.4) and possess unsecured debts below the \$107 307.20 threshold (figure 12.5). It is also easier for a debtor to gain approval for a debt agreement, with only a majority of creditors, rather than 75 per cent in the case of PIAs, required to vote in favour of the agreement.

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## 12.3 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 (AFSA 2014d).

Under the current framework, certain cases of business failure may be covered by both the corporate and personal insolvency regimes (AFSA 2014d), 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.

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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, and both forms of insolvency are encompassed 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 (AFSA 2014d).

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 costs associated with the creation of, or consolidation in, a single new regulator, retraining practitioners, and legal uncertainty around which new jurisprudence is established. 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 2014; Chartered Accountants ANZ, sub. DR52, p. 3). 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 any change were implemented.

At this time, the Commission is not 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 separate personal and corporate insolvency frameworks, 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 12.1). 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),

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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 is 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 a divorce settlement or medical costs — reasons not related to the running of a business.

In response to the Draft Report, some participants — including ARITA (sub. DR53), AICM (sub. DR62), and Chartered Accountants ANZ (sub. DR52) — supported the idea of bankrupts continuing as company directors, specifically in situations involving no fraud or malfeasance, and where the causes of bankruptcy do not indicate a lack of ability to fulfil the duties of a director. However, participants also noted that this provision is currently allowed for through application to the courts (*Corporations Act 2001* (Cth) s 206GA), and argued that the current situation should be upheld (sub. DR62, p. 9 and sub. DR52, p. 3).

The Commission agrees that the current blanket exclusion from directorship is a blunt regulatory tool, and may be unjustified in some cases. However, overall, it considers that the current process requiring application to the courts is an appropriate balance between a general safeguard for the community and removing restrictions from individuals in specific circumstances where they may not be justified.

### A long bankruptcy period can be seen as an excessive penalty

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 due to concerns that bankruptcy was ‘too easy,’ and difficulties relating to identifying when bankruptcy was brought about by ‘misfortune’ rather than ‘misdeed’ (Explanatory Memorandum, Bankruptcy Legislation Amendment Bill 2002). Therefore, the restrictions highlighted above will apply to a bankrupt individual for at least three years, unless the bankruptcy is annulled.

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, whereby new business owners 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,

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more onerous restrictions on bankrupts may increase the ‘risk tolerance’ required by individuals 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.

While this may not be pronounced for first-time business owners — particularly those in small business who may not have actively informed themselves of insolvency laws — for those that have failed once, the spectre of bankruptcy can loom large in any consideration of efforts to ‘restart’ a second business. It is therefore important to carefully balance the competing policy goals of protecting creditors and consumers, and encouraging entrepreneurship when determining the optimal duration of the company director exclusion period.

Bankruptcy legislation that does not excessively penalise business failure can improve productivity by ensuring that valuable resources are not trapped in inefficient firms (OECD 2015c). It has also 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.

### Reforms in other jurisdictions

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).

In 2004, the United Kingdom altered their bankruptcy laws to reduce the exclusion period from three years to one year (box 12.2). 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 (The Insolvency Service 2015a). 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. Evaluations of the UK reform indicate that it provided some benefits. 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

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such a policy is associated with an increase in the average rate of self-employment of up to 3.9 per cent (Armour and Cumming 2008). Additionally, an evaluation of the bankruptcy reforms conducted by the UK Insolvency Service (The Insolvency Service 2007) identified that the reforms led to a reduction in discrimination, some speeding up of the rehabilitation of bankrupts, and played a ‘small part’ in encouraging business set up.

However, the evaluation also noted that the reforms themselves did not go the full way towards quick rehabilitation, due to factors in the broader economy:

The insolvency provisions of the Act have not yet affected the ‘fear of failure’ and a bankrupt’s ability to recommence trading is still hindered by a bankrupt’s restricted access to the financial market and business’s attitudes to bankrupts. (The Insolvency Service 2007, p. 7)

Such an outcome is to be expected as commercial behaviour and culture takes time to fully incorporate legal reforms.

#### **Box 12.2 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 United Kingdom 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. Prior to these reforms, debtors would typically be discharged three years after commencing bankruptcy. Following the reforms, a bankrupt will be discharged one year after bankruptcy commences.

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). 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. There is limited data available, however a 2007 review found that the full achievement of these goals had been hampered by a lack of public awareness of the reforms and the failure of lenders to change their behaviour in line with the new laws (The Insolvency Service 2007).

In addition, there have been moves towards similar reforms in Ireland. A recent report by the Joint Committee on Justice, Defence and Equality recommended that the term of bankruptcy should be reduced from three years to one, with the ability of the Official Assignee to extend the period to up to three years in certain circumstances (Houses of the Oireachtas 2015). The Committee also observed support for reducing the period of income payments from five years to three. These reforms were recommended on the basis of a

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number of potential benefits including aiding the economic recovery of the State, and enabling bankrupt individuals to contribute positively and quickly to the economy (Houses of the Oireachtas 2015).

### Proposed reforms to restrictions

Overall 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), although the current rates of debt recovery are very low. 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 retaining the capacity for courts to increase exclusion periods in a manner more targeted at misconduct. This is also in line with proposed reforms in Ireland. Considering this, and observing the benefits from 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.

Such extensions should be imposed under the existing grounds in section 149D of the Bankruptcy Act, including non-payment of compulsory income contributions or engagement in misleading conduct. The Commission notes that objections to discharge are relatively rare at present — data provided by AFSA indicate that extensions were enforced for approximately 4.5 per cent of all bankrupts due for discharge in 2014-15.<sup>51</sup> As can be expected, where bankruptcy was initiated by a debtor through a debtor's petition (90 per cent of bankruptcies), objections to discharge represented 3.4 per cent of all cases. However in the case of bankruptcies initiated by a creditor through a sequestration order, objections to discharge represented 16.8 per cent of the total in 2014-15 (figure 12.8). This supports the notion that there is an increased likelihood of cooperation by debtors who initiate bankruptcy through a debtor's petition.

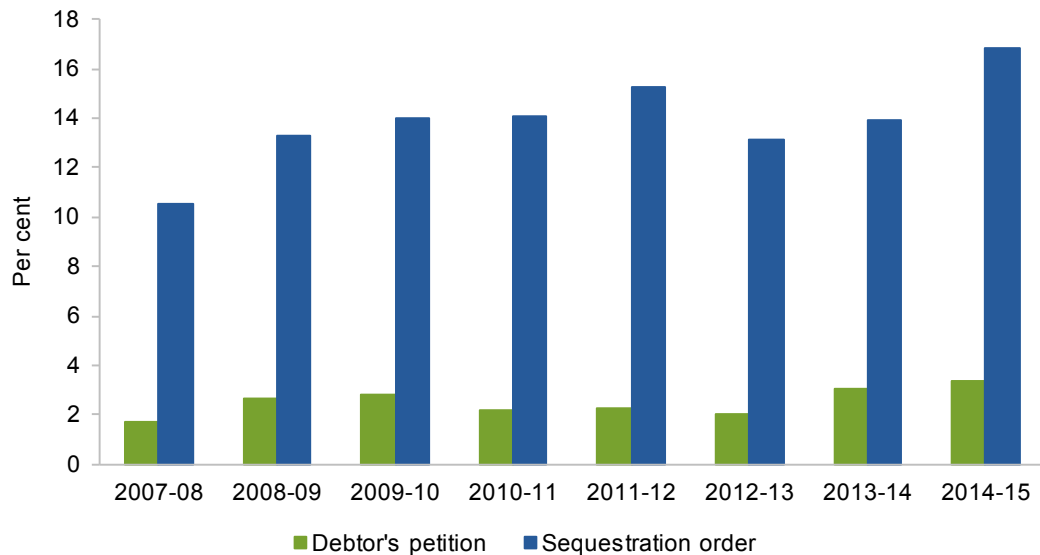
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<sup>51</sup> The overall figure may also be inflated since multiple objections may be lodged against the same debtor.



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Figure 12.8 Bankruptcies where an objection to discharge is filed



Source: Data provided by AFSA

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If the default length of bankruptcy is reduced, objections to discharge may increase, particularly in relation to failure to pay contributions given the shorter time frame. However, the total number of extensions is unlikely to be a significant share of all bankrupt individuals. Even if the frequency of extensions rose sharply, the new system would still represent a more tailored approach, differentiating on the basis of the conduct of the debtor.

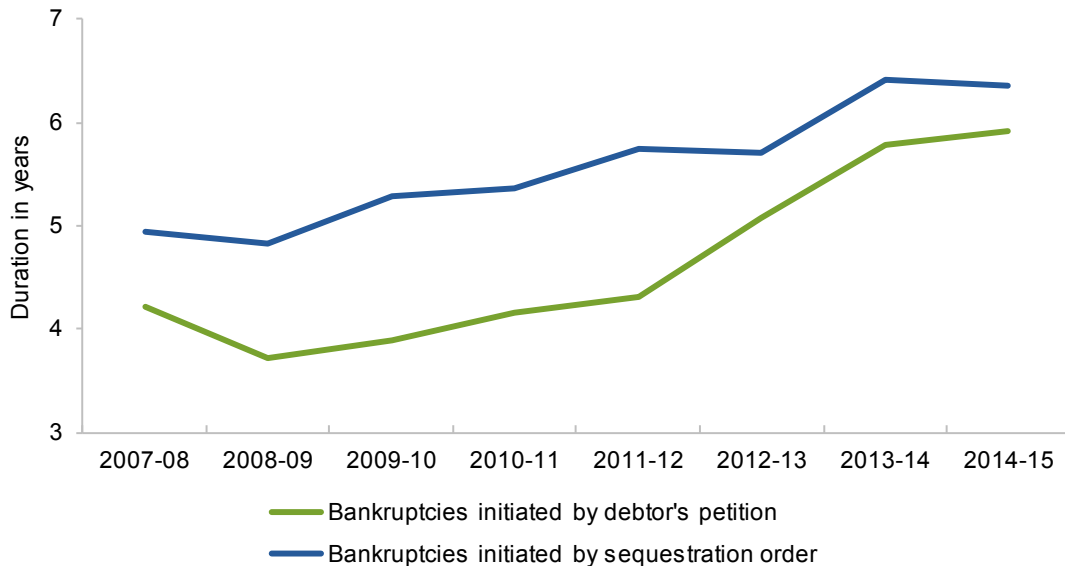
In relation to the duration of bankruptcy for different types of debtors, data provided by AFSA indicate that there is little difference in the duration of bankruptcy between those who initiate it themselves, and those who are placed into bankruptcy by a creditor. Where there is no objection to discharge, the average length of bankruptcy for those discharged in 2014-15 is 3 years for debtors whose bankruptcy was initiated by debtor's petition and 3.2 years when bankruptcy is initiated by a sequestration order.<sup>52</sup> Where there was an objection to discharge, bankruptcies initiated by debtor's petition lasted 5.9 years and bankruptcies initiated by a sequestration order lasted 6.4 years on average. Since 2008-09, the average length of extended bankruptcy periods for both types of debtors have increased, with the gap between the two types narrowing (figure 12.9).

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<sup>52</sup> The difference between these figures may reflect the fact that bankrupt debtors take longer on average to submit a statement of affairs when bankruptcy is initiated by a creditor through a sequestration order, as opposed to those debtors who have already prepared petitions when they initiate bankruptcy themselves.

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Figure 12.9 Duration of extended bankruptcy periods



Source: Data provided by AFSA

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The Commission does not propose forcing any behavioural change on lenders in order to facilitate the financial rehabilitation of bankrupts. Instead, in order to go some way to differentiating between ‘honest’ and ‘culpable’ bankrupts, the default period should only be applied in cases where there has been no misconduct. Further, to assist the transition in culture and behaviour from the financial market, any extension to a restriction period should be formally recorded on the National Personal Insolvency Index. This serves as a signal to prospective lenders regarding the nature of the individual’s bankruptcy, specifically whether it involved misconduct. As with the experience in the UK, these changes are unlikely to have a pronounced, immediate effect, but should provide an overall signal to bankrupts and potential lenders that, over time, should lead to some shift in culture and encourage ‘re-starts’.

As previously mentioned, bankrupts may face restrictions in terms of their employment (box 12.1). 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. Following the Draft Report, the Commercial and Property Law Research Centre of the Queensland University of Technology agreed with the need for review of occupational restrictions, and noted that:

... the circumstances in which bankruptcy (and other personal insolvency administrations) will be a mandatory or discretionary bar to participation in a particular occupation are difficult to

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identify, often inconsistent, and appear to lack a consistent and justifiable policy rationale. (sub. DR64, p. 2)

Therefore, in order to ensure that only valid restrictions remain, 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.

#### RECOMMENDATION 12.1

The *Bankruptcy Act 1966* (Cth) should be amended so that, where no offence has occurred, a bankrupt is automatically discharged after one year. Specifically, this should apply to restrictions relating to overseas travel, holding an office under the *Corporations Act 2001* (Cth), employment within certain professions and access to personal finance.

The trustee, and the courts, should retain the power to extend the time until the bankrupt is discharged for a period of up to eight years if there are concerns regarding the bankrupt's conduct. Any extensions should be recorded on the National Personal Insolvency Index.

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.

### Continuation of excess income payments

In response to the draft report, the Commission received a number of submissions supporting the proposed reduction in the bankruptcy period (see ARITA (sub. DR53), Chartered Accountants ANZ (sub. DR52), AICM (sub. DR62) and the Commercial and Property Law Research Centre (sub. DR64)). However, a commonly raised concern was whether there should be an obligation for discharged bankrupts to continue to make excess income payments if they are able to do so, so that creditors are not disadvantaged (see ARITA (sub. DR53), Chartered Accountants ANZ (sub. DR52), and ABA (sub. DR63)). Currently, individuals are required to make excess income payments to the trustee corresponding with 'contribution assessment periods' that end upon discharge or annulment (s 139K). Therefore, in the absence of any other changes, if the default bankruptcy period were to be reduced in line with recommendation 12.1, the average time period where bankrupts are required to provide income contributions would also be reduced.

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There may be some benefit in separating the requirement for excess income payments from other restrictions linked to the length of the bankruptcy period. This would mean that individuals who earn an income above the threshold amount could continue to make payments to creditors after being discharged from bankruptcy, while not being hindered by other associated restrictions such as those affecting employment. This idea was considered by the Attorney-General's Department in 2009:

There is no necessary connection between liability for contributions and discharge. A bankrupt could be required to pay contributions for a three year period. There are many debtors who choose voluntarily to enter into a debt agreement where the only available asset is income. One of the risks with a shorter bankruptcy period (particularly if there is no requirement to make contributions from income) is that debtors who can afford to pay will choose bankruptcy as the easy option. (2009, pp. 2–3)

By upholding the current time frame for the collection of contributions, bankruptcy would not become an 'easy option' for debtors. Lifting employment and directorship restrictions could also enable former bankrupts to more easily, and potentially more quickly, repay their debts. Such a change would also be consistent with the current situation in the UK, where trustees can apply for an 'income payments order' that may extend beyond discharge, but for no longer than three years (*Enterprise Act 2002* (UK)).

The ABA (sub. DR63, p. 4) argued that since most bankrupts are not 'entrepreneurs', increasing the ease of bankruptcy for debtors would be unwarranted. However, despite the relatively small number of 'entrepreneurial' bankrupts, the potential benefits to this group are large — amplified by the fact that business owners who have previously set-up and closed a business are more likely to succeed with their next business (see chapter 1). The implementation of these changes, alongside the suggested safeguards and existing capability of the courts to punish misconduct, would promote the 'fresh start' goal of bankruptcy, whilst ensuring that creditors are not unfairly disadvantaged through the continuation of excess income contributions.

#### RECOMMENDATION 12.2

The obligation of bankrupts to make excess income contributions to the trustee should remain for three years. The period of excess income contributions can be extended at the discretion of the trustee to up to eight years. If the period of bankruptcy is extended beyond three years, then excess income contributions should be required until discharge.

## 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

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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. Some business owners siphon their assets to related parties (such as their partner 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 3). This may prevent creditors from recovering the full value of provided funds and therefore discourage creditors from funding riskier entrepreneurs hoping to start a business. The issue of whether a bankruptcy 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).

Trusts can also be used by business owners in ‘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 2015c). 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 Discussion Paper on the Reform of Australia’s Tax System. In addition to reforms within the tax system arising from that process, consideration should be given to applying any regulatory responses designed to prevent illegitimate income splitting in a bankruptcy context.

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 two year period preceding bankruptcy (*Bankruptcy Act 1966* (Cth) s 265). Failure to disclose this information may result in a one year imprisonment.

In response to the Draft Report, ARITA stated that they were ‘not aware of any general shortcomings in the existing statutory powers ... to recover assets’ (sub. DR53, p. 7). 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. The Commission considers that these matters are best considered in these broader contexts, rather than through this inquiry’s lens of business-related personal insolvency.



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## 13 Corporate restructuring and insolvency: frameworks

### Key points

- The corporate insolvency system performs an important economic role, facilitating exits in a manner that provides procedural certainty to creditors and encourages 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 to restructure economically viable companies, and where that is not possible, to provide an expedient, effective and orderly process for winding up a company.
- The current process contains three formal 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 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 and potentially undesirable.
- Nonetheless, there is scope for reform, particularly in relation to the timing and effectiveness of restructuring, and ensuring that the liquidation process is as inexpensive and 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 and that it balances and recognises the legitimate interests of other parties including employees, lenders and trade creditors.

This chapter considers the objectives of the insolvency system and examines how the existing Australian insolvency processes meet these objectives. This examination informs the Commission's consideration of the scope for reform of insolvency processes set out in chapters 14 and 15.

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## 13.1 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 accounting, economics and law (box 13.1). As such, the meaning of insolvency can vary depending on the context.

#### Box 13.1 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 firm’s 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.

Determining the precise moment of insolvency takes 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 14).



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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 matters relating to the timing of insolvency, the Commission has adopted the s95A definition. The issues that this can lead to are addressed by targeted recommendations (chapter 14).

## **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, an effective insolvency system should allow for a viable restructured company to emerge from the process in a more efficient form, or where this is not possible, expedient closure should allow for the redeployment of employees and capital to more productive uses at least cost.

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

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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 business exits in Australia are of small, rather than large, businesses. In 2013-14, companies employing fewer than five staff (including non-employing companies) accounted for 92 per cent of company exits, and companies employing fewer than 20 staff accounted for 98 per cent (ABS 2015d unpublished). While failures represent 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, given the large number of small businesses, but also reflecting the 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 (such as in supply chains).

Specifically in relation to insolvency, the Australian Securities and Investments Commission (ASIC) reports indicate that, in 2013-14, 81 per cent of the 9459 initial external administrators’ reports related to companies with fewer than 20 employees (ASIC 2014e). 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 in assets at insolvency.

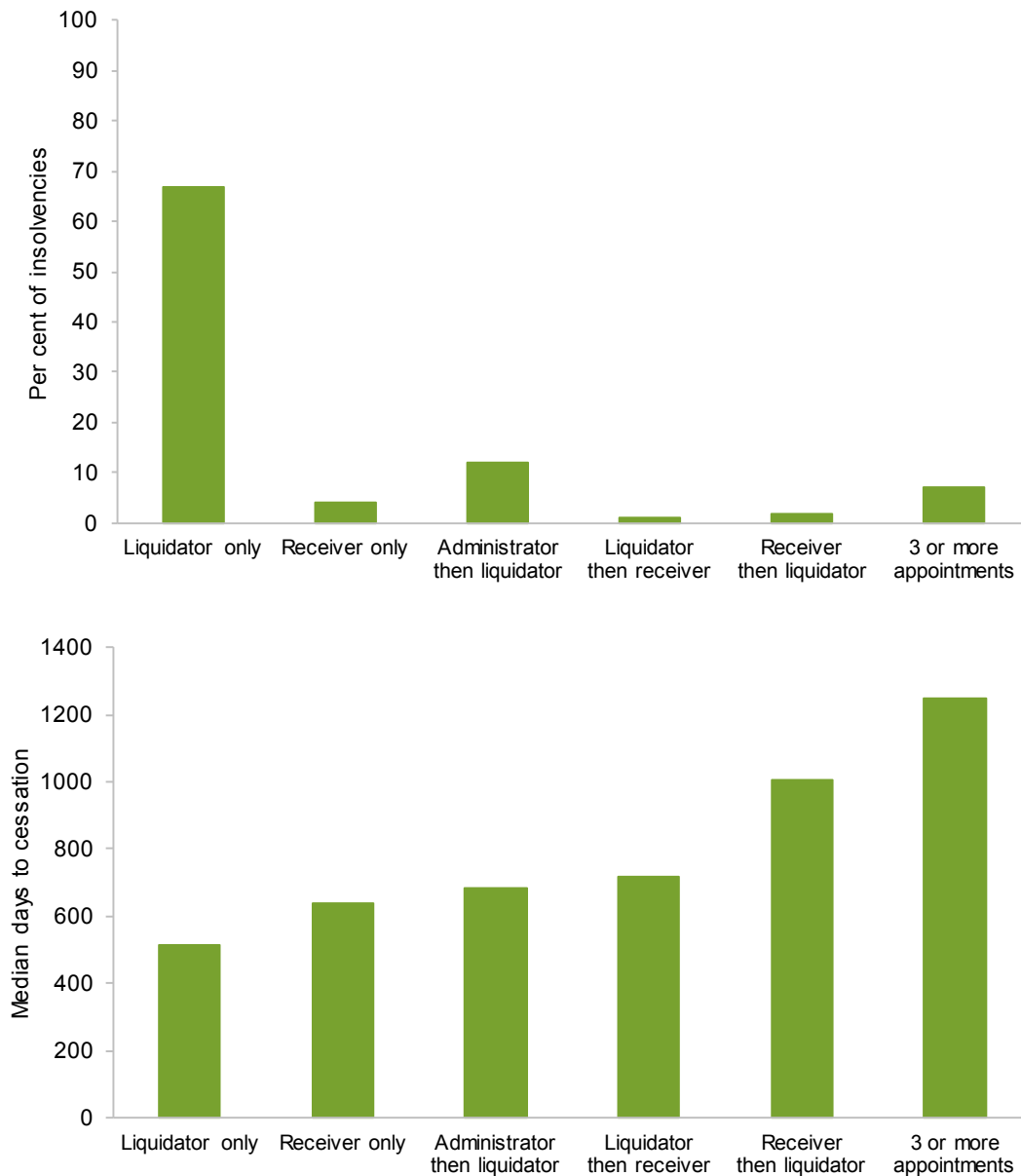
By industry, the ‘Other’ (business and personal) services (26 per cent), construction (23 per cent), accommodation and food services (9 per cent), and retail trade (9 per cent) industries together made up more than half of all companies entering insolvency in 2013-14. In contrast, relatively large industries (which are typically characterised by large businesses) such as mining, health care and education accounted for approximately 1 per cent of insolvencies each.

### **Pathways to cessation for insolvent companies**

The bulk of insolvency appointments will result in a business cessation (that is, the business being deregistered and ceasing to exist as a standalone entity). The different forms and combinations of insolvency appointments that can occur create several different paths to cessation (figure 13.1).

**Figure 13.1 Paths to cessation of insolvent companies<sup>a</sup>**

Cessations from April 2005 to February 2015



<sup>a</sup> Data is for companies who appointed an insolvency practitioner and at a later date, became deregistered. Does not include members' voluntary wind ups. Companies whose deregistration date exceeded 365 days after the termination of their last practitioner appointment (about 4 per cent of cases) have been excluded. Number of days refers to days elapsed between the appointment of the first insolvency practitioner and company deregistration. Appointments may be concurrent – for example, a liquidator may be appointed after the appointment of an administrator, without the administrator's appointment ceasing.

Source: ASIC administrative data

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In over two-thirds of cases, an insolvent company progresses to deregistration through the appointment of a single liquidator (with no other appointments). This is also the shortest path to cessation, with the median time from the appointment of the liquidator to deregistration being around 520 days. The next most common path to cessation is the appointment of an administrator followed by a liquidator (which occurs in about 12 per cent of insolvency-triggered deregistrations).

Receivers are appointed in around 11 per cent of insolvency-triggered deregistrations. While it varies across companies, overall, the data suggests that the appointment of a receiver lengthens the time between the first appointment of an insolvency practitioner and cessation.

### 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 are 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.<sup>53</sup>

Overall, the data suggests that insolvencies are dominated by small companies that have exhibited poor management of cash flow and business strategy.

## Objectives of the insolvency system

### Current objectives

In terms of overarching objectives of insolvency law, a generally accepted (ARITA 2014a) 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.

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<sup>53</sup> Such breaches include matters other than fraud, including breaches of directors' duties including to perform duties in good faith and not use information or their position dishonestly, and to not engage in insolvent trading, or a breach of the obligation to keep financial records.

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- 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 13.2), a dominant feature of the Australian system is a focus on the creditor in preference to the 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 [countries] have more of a bias towards the preservation of the ongoing nature of organisations in financial distress. (ARITA 2014a, p. 5)

DibbsBarker (sub. DR46, attachment 2, pp. 9-13) also noted a number of differences between the approach to insolvency in Australia and the 'business rescue culture' in some other countries, including the Australian focus on:

- the debtor as a failure or wrongdoer
- creditors' rights and their enforcement
- the rights of individual creditors preferred over the interests of the company and creditor body as a whole; and
- intervention at later stages, having ignored (or not acted) on early signs of financial distress.

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### Box 13.2      **The objectives of overseas restructuring mechanisms**

The creditor-focused Australian insolvency system is most commonly compared 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 2014a).

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, focusing 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 in the 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.

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The objective of Australia's system of voluntary administration, as stated in 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 for economically viable companies, without providing incentive for strategic behaviour by debtors and creditors. If restructure is not possible, the insolvency system should aim to provide an efficient (expedient and inexpensive), effective and orderly process for winding up the company. This process should involve consideration of creditors, as well as other stakeholders, and provide certainty regarding future developments. 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, whilst the Commission considers that the current statutory objectives are

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appropriate, if read broadly, in order to give effect to those statutory objectives, the current system needs to be realigned to give greater focus to speed and effectiveness of winding up processes, and allowing genuine opportunities for restructure, over absolute enforcement of all rights. The Commission's approach to analysing and recommending reforms below and in chapters 14 and 15 is guided by these objectives.

## **13.2 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, schemes of arrangement and voluntary administration (including deeds of company arrangement) exist as options to allow a company to restructure and attempt to continue as a viable entity.<sup>54</sup> Second, where a company is irretrievably insolvent and has no realistic prospect of recovering from financial difficulties, processes to wind up, including various forms of liquidation and receivership, can be used (see below).

### **Informal workouts**

The term informal workout covers a range of private arrangements between a company and one or more 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 small creditors and 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 these workouts both stem from their informality. As private agreements they are flexible and importantly, usually do not 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 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:

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<sup>54</sup> 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 instances relate solely to arrangements with members).



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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)

In the Draft Report, the Commission sought information on the extent of these workouts. The Australian Bankers' Association (ABA) declined to provide information, citing the cost of collection but noted that there is a 'thriving workouts culture and practice by banks which may not be apparent in the wider community' (sub. DR63, p. 3). This sentiment was echoed by McGrathNicol who submitted that

... the list of confidential restructuring projects we have undertaken is extensive and covers businesses of all shapes and sizes, from small private companies to listed multinational entities, across all key industry sectors. (sub. DR60, p. 1)

However, information provided by both the ABA (2015) and individual banks to the Parliamentary Joint Committee on the impairment of customer loans indicates that the proportion of customers whose loans entered difficulty was less than one per cent. While this is more a reflection of the customers' financial status than the banks' willingness to assist, the Commonwealth Bank of Australia reported that:

In the year to 31 March 2015 more than 40 per cent of commercial customers rated as troublesome or impaired returned to a satisfactory position. These data demonstrate our willingness to give customers time to address arrears and return to sustainable payment arrangements. (2015b, p. 8)

While workouts represent situations where banks are willing to assist their clients, information provided to this inquiry (trans., p. 67) and to a Parliamentary Joint Committee into the impairment of customer loans (see, for example, Randles and Randles 2015) provide examples of banks doing the opposite — not working with their clients but instead using 'constructive defaults' involving selective property revaluations.

In the absence of comprehensive data it is difficult to be definitive about the extent to which, on balance, the informal activities of lenders assists restructure. Indeed, it is likely that both circumstances reported above are simultaneously true within the market: normal commercial prioritisation would suggest that banks work to restructure those particular loans in particular areas where they can foresee ongoing profit. However, in respect to particular businesses or parts of their portfolio<sup>55</sup> which do not offer the best ongoing profitability for the bank they may instead allow the business to fail or seek to foreclose at the first available opportunity. In some cases (such as those currently before the Parliamentary Joint Committee on the impairment of customer loans), this could go so far as to orchestrate the conditions to lead to foreclosure.

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<sup>55</sup> One example is loans that appeared profitable at the time they were written but due to changed circumstances, such as better available returns elsewhere, are no longer attractive.

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In such cases where a large creditor is unwilling or unable to provide significant relief, or companies lack a good relationship with their creditors, more formal restructuring 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, 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 of creditors, 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

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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, and cumbersome, some participants in this inquiry noted that schemes have one advantage, that they are not seen as an insolvency process. 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)

Participants also noted that schemes are seen as valuable tools, where Court oversight is appropriate in a 'big business' corporate restructure given the size and complexity of the transactions involved (trans., p. 21).

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. 11-2). As such moratoriums are available in voluntary administration, companies have some incentive to seek that protection.

## **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

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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

A DOCA is an agreement between the company and creditors that follows from a voluntary administration. It is one of the potential means of restructuring a company and moving it away from insolvency. 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. The company's creditors are bound by the DOCA, and 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

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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 of the company.

### **13.3 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 DOCAs) nearly 3 per cent (sub. 20, p. 45). The prominence of liquidation compared to other forms of appointment 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 2008).<sup>56</sup>

There are several forms of liquidation. A members' voluntary liquidation (chapter 11) differs from the other forms in that it is only available when the company is solvent — that is, it is not in financial difficulty. It is initiated by a special resolution (supported by 75 per cent of members) of the company. According to ASIC administrative data, members' voluntary liquidations accounted for around 20 per cent of liquidations undertaken between 1 January 2005 and 1 January 2015. Creditors have no involvement in this process as they will be fully repaid. 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.

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<sup>56</sup> The lower rate of receivership in the United Kingdom reflects reforms to the role of secured credit, discussed in chapter 15.

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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 effectively to 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,<sup>57</sup> and criminal offences, typically in relation to insolvent transactions or breaches of directors' duties (which must be reported to ASIC).

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 times, and must avoid any conflicts of interest (mondaq 2009b).

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).

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<sup>57</sup> Unlike administrators, liquidators have some power to undo voidable transactions through court action. Successful action would return the funds from the transaction to the broader pool for distribution. 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).

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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. 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 2009a). As such, these court appointments are rare.

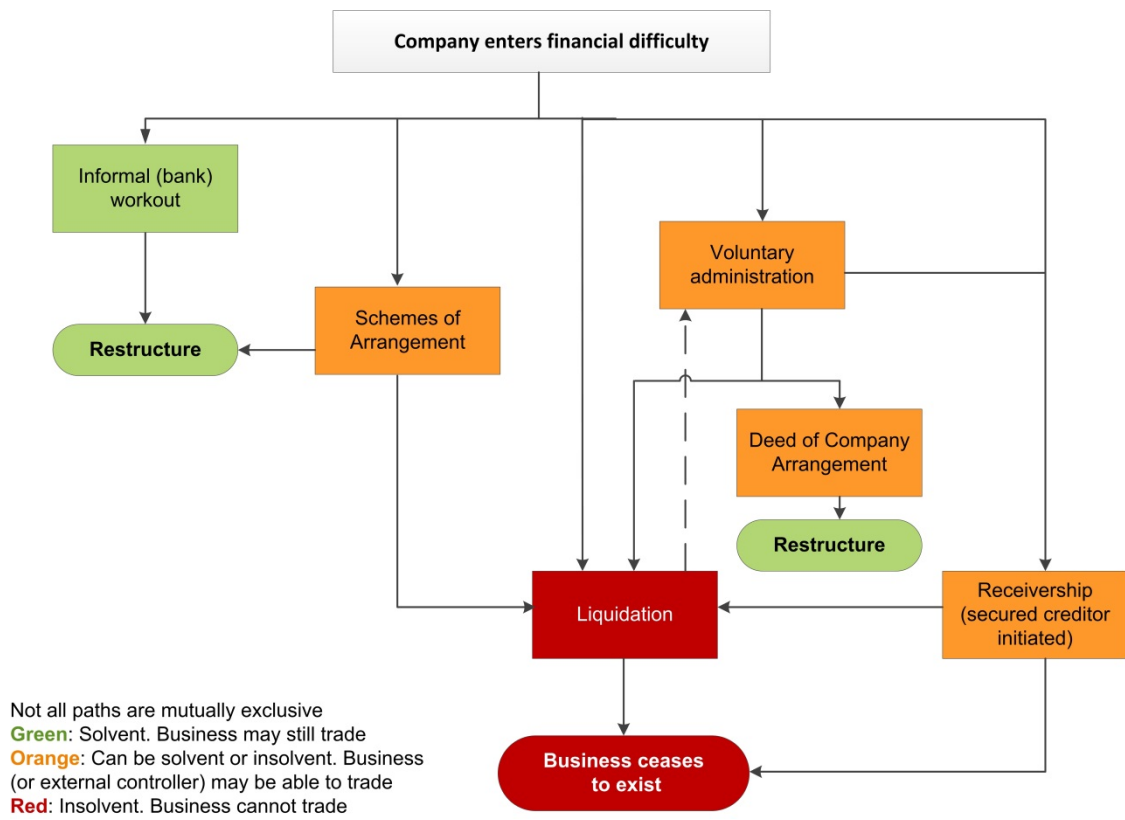
The role and powers of a receiver are dependent on their instrument of appointment and are typically tied to the secured property itself. This could be a core component of a business (such as the business's premise or the owner's house) or a useful but nonessential asset that the business could survive 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.

## **13.4 Scope for reform of insolvency processes**

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 13.2 presents a simplified summary of the processes that may be available to a business entering financial difficulty.

Figure 13.2 The restructuring and insolvency framework in Australia



### Areas for potential reform

While the system is generally 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 four key questions: does the system promote effective restructuring, are assets redeployed efficiently in the event of failure, does the system appropriately balance the interests of all affected parties, and does the system achieve the necessary compliance outcomes to ensure market confidence and efficiency?



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## 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.<sup>58</sup>

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).<sup>59</sup> 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 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), a focus of restructure to only those (elements of) businesses that are attractive to particular creditors (rather than on companies that are overall economically viable), as well as the possibility that deals could fall through, or in fact be later undone by liquidators.

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<sup>58</sup> These figures include both companies under administration and companies operating under a DOCA. The percentages have been calculated as a proportion of all companies who go through a voluntary administration process and that are currently registered or deregistered. This does not include companies that are still in external administration as of 26 February 2015.

<sup>59</sup> Care needs to be taken in interpreting such figures given the potential for sample bias. Specifically, only those companies in some type of financial difficulty are likely to enter administration or a DOCA, and so they are likely to be more prone to eventual failure than the broader stock of companies.

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## Are assets redeployed efficiently in the event of failure?

In terms of unlocking capital that could potentially be applied to productive uses, and allowing employees to find other jobs 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 593 days, or 1.6 years with 80 per cent of processes resulting in deregistration within 1070 days (2.9 years).<sup>60</sup>

## 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.

## Does the system achieve the necessary compliance outcomes?

One feature of the Australian insolvency system is the use of liquidators to not only ascertain and distribute funds, but also to act as investigators for enforcement purposes:

... liquidators are required to investigate the conduct of parties leading up to the liquidation, and report offences and other misconduct to ASIC, and assist in the pursuit of such misconduct.  
... Payment of the liquidator for that work in itself consumes funds in the administration, often thereby reducing funds, if there are any, available to pay a dividend. (ARITA, sub. 31, p. 30)

These costs are passed on to the creditors (as liquidators are paid out of the recovered funds) but also borne by the liquidators themselves. ARITA (sub. 31, p. 30) estimated that liquidators fund over \$47 million of unpaid remuneration per annum from their own resources.

Such expense could be justified if it were required as an appropriately targeted approach to address the risk of illegality in conduct that can lead to liquidation. However, the level of

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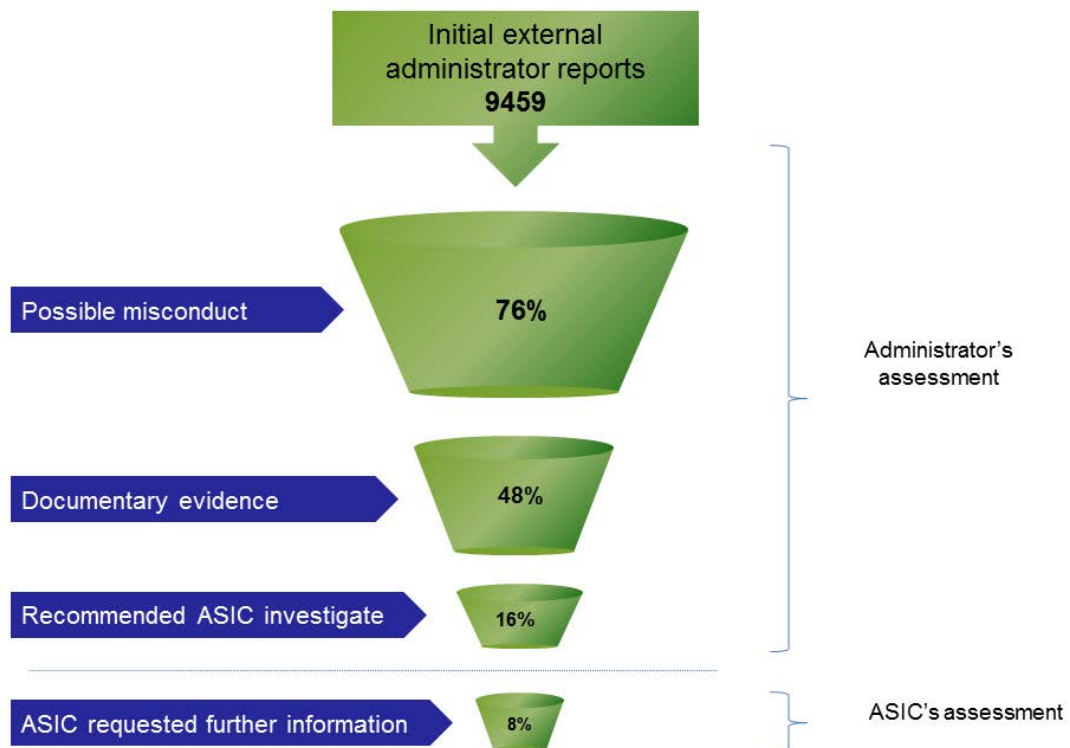
<sup>60</sup> This figure represents insolvency processes only and as such, excludes members' voluntary liquidations which are instead discussed in the context of voluntary business exit (chapter 11).

investigation may always not be appropriate for the liabilities at stake, and the level of enforcement pursued. Nearly half of all insolvency practitioner appointments are for companies with less than \$250 000 in liabilities, and those companies are likely to be small: some 70 per cent of them have less than 5 full time equivalent employees (appendix F).

Additionally, the information provided through these investigations is not always acted upon, as ASIC and the external administrators in effect apply a series of filters before determining to investigate further. Indeed, of the 7218 external administrator reports that identified possible misconduct in 2013-14 (out of a total of 9459 reports), ASIC requested further information in just over 10 per cent of cases, though this in part reflects the views of the external administrators (figure 13.3).

Figure 13.3 **Filtering regulatory action a,b**

ASIC response to external administrators' reports of possible misconduct, 2013-14



<sup>a</sup> Data relating to documentary evidence is for pre-appointment misconduct. In 4446 reports, the external administrator had documentary evidence to support allegations of pre-appointment misconduct. There are 358 reports where the external administrator is aware of another person with documentary evidence to support allegations. However, there are 280 reports in which had both, leaving a total of 4524 reports with some documentary evidence. <sup>b</sup> Data relating to ASIC requests for further information reflects both follow up based on the administrators' recommendation, and, separately, ASIC's own risk assessment.

Source: ASIC (2014e), pers. comm ASIC 16 September 2015

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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 2014e, pp. 23-4)

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.

### **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, these contribute to a regime that the Honourable Wayne Martine, AC QC, 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 2009, p. 13)

Martin CJ went on to note the impact that continuous disclosure requirements can have (2009, 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 (2009, 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)

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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.

**FINDING 13.1**

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

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## 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 13.3). 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 13.3 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 (chapter 14) 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); CAMAC (2004)

### 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. ...

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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 2004, 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 data (Eckbo 2008) indicate 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, and merger with another company resulted 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.<sup>61</sup> Evidence submitted at the time of

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<sup>61</sup> It is possible that substantial changes in the chapter 11 process over such a long period could reduce the value of a long-term average. However, similar to the Australian system, Chapter 11’s ‘fundamental structure and principles have not been amended since [its introduction in] 1978’ (Levin and Klee 2012, p. 2).

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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 35 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 14).



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Following the draft report, participants (including ARITA (sub. DR53) and the Business Law Section of the Law Council of Australia (sub. DR55)) agreed that there was no need for wholesale change to adopt the Chapter 11 model.

In the Commission's view, increasing the role of the courts in overseeing 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 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, development of new jurisprudence, 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.

**FINDING 13.2**

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.

### **Reform should focus on specific, not fundamental, change**

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 13.1).

**Table 13.1 Comparison of insolvency regimes<sup>a</sup>**  
2014

	<i>Overall 'Resolving Insolvency' rank</i>	<i>Cost (% of estate)</i>	<i>Recovery rate (cents in the dollar – secured debt)</i>	<i>Reorganisation proceedings index (0-3)</i>	<i>Creditor participation index (0-4)</i>	<i>Strength of insolvency framework index (0-16)</i>
Australia	14	8.0	81.9	0.5	3	12.0
Canada	6	7.0	87.3	2.0	3	13.5
New Zealand	28	3.5	83.6	0.5	2	8.5
United Kingdom	13	6.0	88.6	1.0	2	11.0
United States	4	8.2	80.4	3.0	3	15.0

<sup>a</sup> 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 the reorganisation of economically viable companies 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 chapters 14 and 15.

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# 14 Corporate restructuring reforms

## Key points

- The Commission has identified a range of reforms to improve the effectiveness of restructuring options. These focus on the timing of restructure and removing impediments to effective restructuring.
- Some reforms aimed at improving the prospect of restructure can be open to abuse by those seeking to avoid liability or scrutiny. As such, the Commission has endeavoured to provide safeguards to maintain good governance.
- Voluntary administration should only be available to companies that are economically viable.
- The *Corporations Act 2001* (Cth) should be amended to provide for a ‘safe harbour’ defence to allow directors to obtain independent restructuring advice without liability for insolvent trading.
  - The defence should be subject to governance requirements, including that the restructuring advisers be registered, that the company be solvent at the time of the adviser’s appointment and that the adviser is presented with complete books and records upon appointment.
- Some reforms are required to expedite and improve the certainty for parties to ‘pre-positioned sales’ (the sale of businesses that are organised immediately before, but given effect during, a formal insolvency appointment).
  - Specific provision should be made for small companies to use such sales as a low-cost means of restructure.
- Ipso facto clauses that allow termination of contracts solely due to insolvency events should be prevented from operating until a liquidator has been appointed. Breaches of other contract terms (such as failure to pay or otherwise not perform) would still allow termination.
  - The presence of an administrator (who guarantees liabilities incurred after appointment), and the ability to apply to court in the event of undue hardship, provide protection to creditors.

As identified in chapter 13, the Commission considers there is scope for reform to specific aspects of Australia’s restructuring and insolvency system. This chapter focusses on the first element of those reforms — the scope for a genuine opportunity to restructure a company that is experiencing financial difficulty. The second element, focussing on the efficient operation of the winding up process and broader insolvency reforms is discussed in chapter 15.

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## 14.1 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 13, 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 13).

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 distinguishing between circumstances where restructuring is possible, as opposed to where winding up is inevitable, should provide both directors contemplating restructuring and creditors (including suppliers) responding to it with a

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clearer signal of the role of voluntary administration. In the draft report, the Commission sought to provide such a signal by limiting the availability of voluntary administration so that it was not available to insolvent companies.

Participants — including the Australian Institute of Company Directors (AICD, sub. DR43), PPB Advisory (sub. DR42) and the Commercial and Property Law Research Centre at the Queensland University of Technology (sub. DR64), among others — pointed to practical issues with this approach. Several of these issues stem from the definition of insolvency, discussed in chapter 13. First, judging the precise moment of insolvency can be difficult and imprecise. Second, as the Australian Securities and Investments Commission (ASIC, sub. DR58, pp. 10–11) noted, it is possible for an economically viable business to become technically insolvent at a given point in time. As such, preventing a company that is capable of returning to profitability in the medium term (within, say, three years)<sup>62</sup> from availing itself of administration, and instead forcing it into liquidation, could result in the destruction of otherwise economically valuable activity, and incur unnecessary transaction costs.

Further, as DibbsBarker noted, the protections and mechanisms available in voluntary administration can improve the likelihood of restructuring for a company that is technically insolvent:

... [the company] requires the benefit of the moratorium granted by administration to deliver a deed of company arrangement proposal, there are funds available to enable the company to continue as a going concern during the administration, and that deed has the potential to turn the company around or deliver a better outcome for creditors than otherwise would have been the case in liquidation, then the company should be able to avail itself of the regime. (sub. DR46, p. 2)

The Commission acknowledges that these issues render the exclusion of insolvent companies from administration undesirable. Instead, in order to better align the practice of voluntary administration with its stated intention, the Commission considers that voluntary administration should only be available to those companies that are economically viable in the medium term. In other words, only those with some prospect of restructure should be allowed to use a restructuring mechanism. A focus on viability over insolvency was supported by a number of participants, including ASIC (sub. DR58), Chartered Accountants Australia and New Zealand (sub. DR52) and ARITA (sub. DR53).

Shifting the line away from ‘insolvency’ does not avoid definitional issues — merely transfers them to ‘viability’. As identified in chapter 13 (box 13.1), viability relates to the net present value of the company as a going concern, and involves a judgment that the

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<sup>62</sup> Three years is provided as an indicative ‘medium term’ period for a company. However, this may vary depending on the characteristics of the industry in question — for example, the medium term for a small retail business may differ substantially to what would be considered the medium term for a large international mining company. In the context of recommendation 14.1, it would be up to the administrator’s discretion to determine the applicable medium term for the circumstances of the company in question.

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business, and its creditors as a whole, would be better off from the company's continuation (in some form), rather than selling its assets in a liquidation. ARITA submitted that viability, like insolvency, required the consideration of a number of factors, including:

- that there is a business to rescue or restructure as a going concern
- that the business is sustainable for its purpose
- that it has current and future profitability, and
- has access to future capital requirements. (sub. 53, pp. 8–9)

DibbsBarker suggested that viability was complex (involving the financial status of the company, and the willingness of others to support it) but depended on a core question:

... is the firm able to attract sufficient capital to continue as a going concern both in the short term and the medium to longer term? ... This in turn depends on whether:

- there is a core business that generates positive cash flow or is able to generate positive cash flow at some future point in time; and
- the firm's stakeholders [including directors, management, employees, shareholders and creditors], existing or new, are willing to support the firm on terms that enable the business to generate that cash either now or in the future.

That is, a firm might be able to generate sufficient cash in the future and be viable in the meantime, because of the support of certain stakeholders on certain terms. In that regard, a financially troubled firm is not dissimilar to a start-up. (sub. DR46, attachment 1, p. 4)

The matter of viability will inevitably involve judgment on the part of the administrator. Unlike insolvency, which is examined at a point in time, viability looks at likely future cash flows. While there may be some objective evidence (for example existing lease, supply and sale contracts) that can inform a company's future, forecasting by its nature introduces judgment and uncertainty.

As such, the test of viability should be 'tilted' to avoid uncertainty (and excessive litigation) for practitioners. To give effect to this, a requirement that an administrator form a judgment that the company is *definitely* viable should be avoided. Instead, the Commission considers that, immediately following appointment (that is, within a month), administrators must certify that they have *reasonable grounds to believe* that the company (or a large component entity of it that may emerge following a restructure) *is capable of being a viable business*. The calculations and evidence required to form such a judgment should be a component of their normal course of investigations, thus making any additional compliance burdens marginal at most.

Where the administrator concludes that this is not the case, they should be under a duty to convert the process to a liquidation. ASIC should be given the power to enforce this duty, including through random audit of administrators' records of the grounds for certifying viability in cases where a company has been liquidated within five years of the conclusion of an administration. Focusing administration on the ability to 'salvage' a viable company, and converting to liquidation where this seems unlikely, aligns with the ability of

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liquidators to convert a liquidation into a voluntary administration if they believe there is some prospect of salvage. Further, expediting the shift to liquidation for companies with little to no prospect of viability could reduce the overall costs of their administration and liquidation, to the benefit of creditors.

In the draft report, the Commission also noted the suggestion by Arnold Bloch Leibler to ‘rebrand’ voluntary administration in order to reduce the current stigma around the process (sub. 23, p. 6). While such a change may have some merit as a relatively costless means of improving the potential for effective restructuring, the Commission considers that, in the first instance, its recommended changes should be allowed to operate before any further changes are considered. Cultural change may be slow to follow any shift in the law, but if the Commission’s recommendations succeed in aligning voluntary administration with its intended restructuring purpose, lasting change in the market’s perception of companies under administration should also follow. Conversely, renaming the process without first providing evidence of genuine change is unlikely to be effective as creditors would then view the ‘rebranding’ as little more than empty marketing.

RECOMMENDATION 14.1

The *Corporations Act 2001* (Cth) should be amended such that, for an administration to continue, within one month of appointment the administrator must certify they have reasonable grounds to believe that the company (or a large component entity of it that may emerge following a restructure) is capable of being a viable business.

If the administrator is unable to certify this, they should be under a duty (enforceable by the Australian Securities and Investments Commission) to convert the administration into a liquidation.

The Commission appreciates that such reforms are not without potential pitfalls including a 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. (McGrathNicol, sub. 34, p. 3)

The Commission considers that the solution to this tension lies in creating a regulatory system that enables company directors to make informed decisions, free of any distorted incentives and undue barriers. A proposed ‘safe harbour’ to allow directors to receive advice but retain control is one such option.

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## A safe harbour for directors?

As identified in chapter 13, 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, 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).

Since 2004, ASIC reports that they have commenced action for insolvent trading for circumstances involving five companies between 2005 and 2011:

- Two cases involved civil action, both resulting in the winding-up of a company.
- The remaining three cases involved criminal action. In one instance, the action was abandoned. In another, a director was fined and required to perform community service, but was subsequently imprisoned for failing to complete the community



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service. In the third case, two directors were banned from acting as directors for two years and 18 months respectively.

Most recently, there are further criminal matters relating to the prosecution and sentencing of 3 directors of the white goods distributor, Kleenmaid, that are due to be heard in court in October 2015 (ASIC 2014a).

The relative scarcity of insolvent trading actions is in part due to the difficulty in proving 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 allows for 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 form of '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 14.1). A safe harbour would allow directors to make decisions 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 form of safe harbour.

Not all participants were enthusiastic. McGrathNicol noted the theoretical benefits of safe harbour, 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

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has not been our experience that boards inappropriately seek to enter formal insolvency to avoid personal liability. They further 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 14.1      **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)

### Implementing safe harbour

Following the Commission’s draft report, participants generally agreed on the need for a form of safe harbour and focused on the manner of implementation. The discussion centred around safe harbour as a *process* (akin to say voluntary administration) or as a *defence* to an insolvent trading action against a director under s588G of the Act.

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The majority of the participants who commented on safe harbour — including McGrathNicol (sub. DR60), Arnold Bloch Leibler (sub. DR65) and ARITA (sub. DR 53) — proposed that safe harbour operate as a defence.

The main reason for favouring a defence was its private nature, and the effect that would have on the prospects of a successful restructure:

Safe harbour will only ever be considered in the event of the failure of the restructuring effort, liquidation of the company occurring, and pursuit of the directors for insolvent trading. It is at that time that the directors can rely on their compliance with the safe harbour requirements as a defence to the insolvent trading claim. ...

Any public disclosure of financial distress may lead to the same (or more) issues than are currently experienced when appointing a voluntary administrator. In particular, creditors would not have the same personal liability protection for ongoing debts incurred by the company that they have in a voluntary administration (where the appointee is personally liable for payment) and they may be reluctant to continue to deal with the company. They may also more forcefully attempt to recover any debts owed. (ARITA, sub. DR53, pp. 9–10)

The Commission agrees that, on balance, a properly constructed safe harbour *defence* is the best approach to both encourage good corporate governance and improve genuine opportunities for restructure.

Ensuring that the defence functions as intended requires careful consideration: the criteria for accessing the defence; any disclosure required and the advisers used; and the timing and coverage of the defence.

### Criteria for accessing the safe harbour defence

First, the defence should only be available where an adviser has been appointed with the *explicit purpose of providing restructuring advice*, aimed at ensuring the business's continued solvency and ongoing viability, and must be triggered by a specific instance of financial difficulty. This should be evidenced in writing by the directors, and be recorded by the adviser on appointment. As DibbsBarker noted, it is important that the expectations on directors are clear:

... we expect directors to come up with a plan ... [which] needs to identify the specific steps that the firm will take to turn itself around over a defined period ... [the plan] needs to address both the operational and financial changes that need to be made, to deliver sustainable improvement over the medium to longer term. ... Specifically, the advice must have solvency focused outcomes for the purposes of any defence to section 588G. However, to be an effective turnaround plan, the advice needs to have outcomes focused on sustainability, which arguably falls outside the purview of the defence. (sub. DR46, attachment 1, p. 5)

Requiring a 'restructuring purpose' for the appointment of an adviser means that there is no need for an explicit duty to creditors — implicitly, the restructured company will continue to be able to meet its debts or will have reached a mutually agreeable resolution with creditors.

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In order to prevent the company ‘relapsing’ into difficult financial waters, the Commission considers that the advice should address both immediate solvency and medium-term viability (in line with the changes to voluntary administration in recommendation 14.1).

Further, directors should not be able to enter safe harbour when the company is already insolvent — safe harbour should be entered when insolvency is a future possibility, not the present reality (voluntary administration is available to directors of insolvent but viable companies). An independent adviser appointed under safe harbour should be required to verify that ***the company was likely to have been solvent at the time of appointment, and if not, the adviser should withdraw and advise ASIC accordingly***. From this point, the safe harbour protections would cease and any debts incurred after this time would expose the directors to potential liability. It would then be up to the directors to continue trading or determine that an administration or liquidation process should be initiated. The ‘bar’ at this stage is intentionally set at ‘insolvency’ rather than the viability test applied to voluntary administration under recommendation 14.1 to delineate the different, and earlier, role of safe harbour as distinct from voluntary administration.

Importantly, this does not preclude situations where the company was solvent at the time of the appointment, and in the course of the appointment becomes technically insolvent. In such situations the defence would still continue to apply (as long as restructuring advice is being formulated, given and acted upon). This provides directors with an incentive to seek restructuring advice in the ‘twilight’ of insolvency, but protects against the abuse of safe harbour by directors simply seeking legal protection when they are already aware the company is insolvent.

During the advice process, the adviser should be under a similar requirement to ***terminate the safe harbour period if they form the view that restructure into any form of viable business or businesses is not possible***. As with the initial insolvency advice, the directors should then be advised that a formal insolvency process should commence. The company and the adviser would also be required to account for all existing liabilities — safe harbour should not be used as a birthplace for new phoenix companies.

A further prerequisite for accessing the defence should be that, on appointment, the adviser is presented with the ***proper books and records***. In other words, the defence should only be available to those with ‘clean hands’: those who have demonstrated good governance. Directors who lack this, either through intent or omission, will continue under the standard system subject to the existing levels of liability. As ARITA suggested:

... if you’re claiming safe harbour, then you’re going to have to show the liquidator that you had proper books and records on which you based your decisions and your adviser is able to assess. You can’t have safe harbour if you were making your decisions based on which way the wind was blowing. (trans., p. 37)

Presentation of proper books and records serves as a proxy for good corporate governance (preventing abuse of the process from those simply seeking a liability shield) and suggests that should the company later enter liquidation, a faster and more thorough investigation

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should be possible. Advisers should be under a duty to satisfy themselves that the books and records provided are in order, and turn down an appointment where this is not the case. This should provide additional incentive for directors to ensure that the company's books and records are well maintained.

#### Disclosure requirements and type of advisers used

*Appointments should not be publicly disclosed*, as this could damage the prospects of a successful restructure. However, existing ASX continuous disclosure requirements would continue to apply. Instead of public notification, both the adviser and the company should record the date of the appointment, the date of the provision of advice, and board meetings taken to consider implementing the advice.

To access the defence, *safe harbour advisers should be registered as such with ASIC, and be substantially experienced practitioners*. Some argued that the diversity of circumstances that companies can face suggested flexibility was more important than registration. For example, DibbsBarker submitted that:

... a turnaround practitioner might be a company executive and not an adviser (although in large, complex restructurings, advisers will be involved in addition to, for example, a chief restructuring officer). The parties who can assist with a restructuring vary greatly, from turnaround executives, accountants, investment bankers, shadow banking participants and lawyers. The suitability and mix of such persons will depend on the size and complexity of the company and nature of the restructuring. (sub. DR46, p. 3)

However, as ARITA argued, pre-insolvency advice can, in some cases, involve actions targeted at minimising compliance and reducing the effectiveness of enforcement:

This is the problematic end of the pre-insolvency advice, because that is exactly the type of advice that's given to businesses. If you manage your assets in this way, if you manage your books and records in this way, then most of it is going to go away because there won't be the capacity for the investigative work to be done and you'll have gone outside any periods of review. (trans., p. 36)

Similarly, ASIC submitted that:

... the reforms should also require that the safe harbour adviser is an independent, suitably qualified and experienced professional (for example, a registered liquidator acting as a Chief Restructuring Officer). To provide some regulatory oversight to the informal workout process, the safe harbour adviser could be required to: exercise their powers and discharge their duties in good faith in the best interests of the company and all stakeholders; and have a duty to report potential misconduct to ASIC. (sub. DR58, p. 12)

The Commission agrees and considers that appointment of a registered adviser — and the safeguard of regulatory oversight that comes with registration — is an appropriate trade-off for access to the defence. It would be open to companies to appoint any of the specialists identified by DibbsBarker in the normal course of their business, or in addition to the registered safe harbour adviser, to provide specialist input. To improve the overall quality

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of the restructuring advice, the Commission considers that advisers should be of significant standing within the profession, for example with five years' experience. ARITA agreed with the need for expertise and suggested further criteria:

... only professionals who have obtained the qualification of ARITA Professional Membership or are a Registered Liquidator should be able to oversee this process given their innate high level understanding of insolvency law that is required to ensure directors appropriately discharge their duties. Persons without this level of qualification may place creditors and other stakeholders in an otherwise worse position. (sub. 53, p. 10)

The use of such experienced professionals is likely to increase the cost of accessing the defence. However, in terms of the benefits to the directors, the company, and the overall restructuring and insolvency system, the Commission considers that these costs are justified. As with other professions, elements of the registration would be checks of qualifications, continuing professional development and appropriate levels of practitioner insurance.

ARITA argued against allowing the safe harbour adviser to conduct any follow-up appointments on independence grounds (sub. DR53). However, others, saw that the knowledge of the adviser could mean they are in a position to conduct later process in an efficient manner:

While there is a risk of conflict where the restructuring advisor is subsequently appointed, there may be circumstances where the timing and need to utilise the statutory restructuring mechanisms quickly to complete or facilitate a reorganisation (such as a 'pre-pack') make it difficult for a new practitioner to be appointed and familiarise themselves with complex arrangements where there are real commercial time pressures. In such cases, the advisor should be able to be appointed with leave of the Court or a specialist panel. (Arnold Bloch Leibler, sub. DR65, p. 2)

Given the experience, independence and registration requirements proposed for advisers limit the likelihood of malfeasance, the Commission considers that ***advisers should be allowed to perform subsequent insolvency processes with the leave of the court.***

### Timing and coverage of the defence

In relation to the coverage of the defence, the Commission considers that the ***defence should apply for the period from the adviser's engagement until the implementation of the advice is complete.*** DibbsBarker agreed, and noted that the advice is likely to be continuous and varied in nature, from 'emergency' solvency advice at the outset to long-term viability options later in the process, but that, overall:

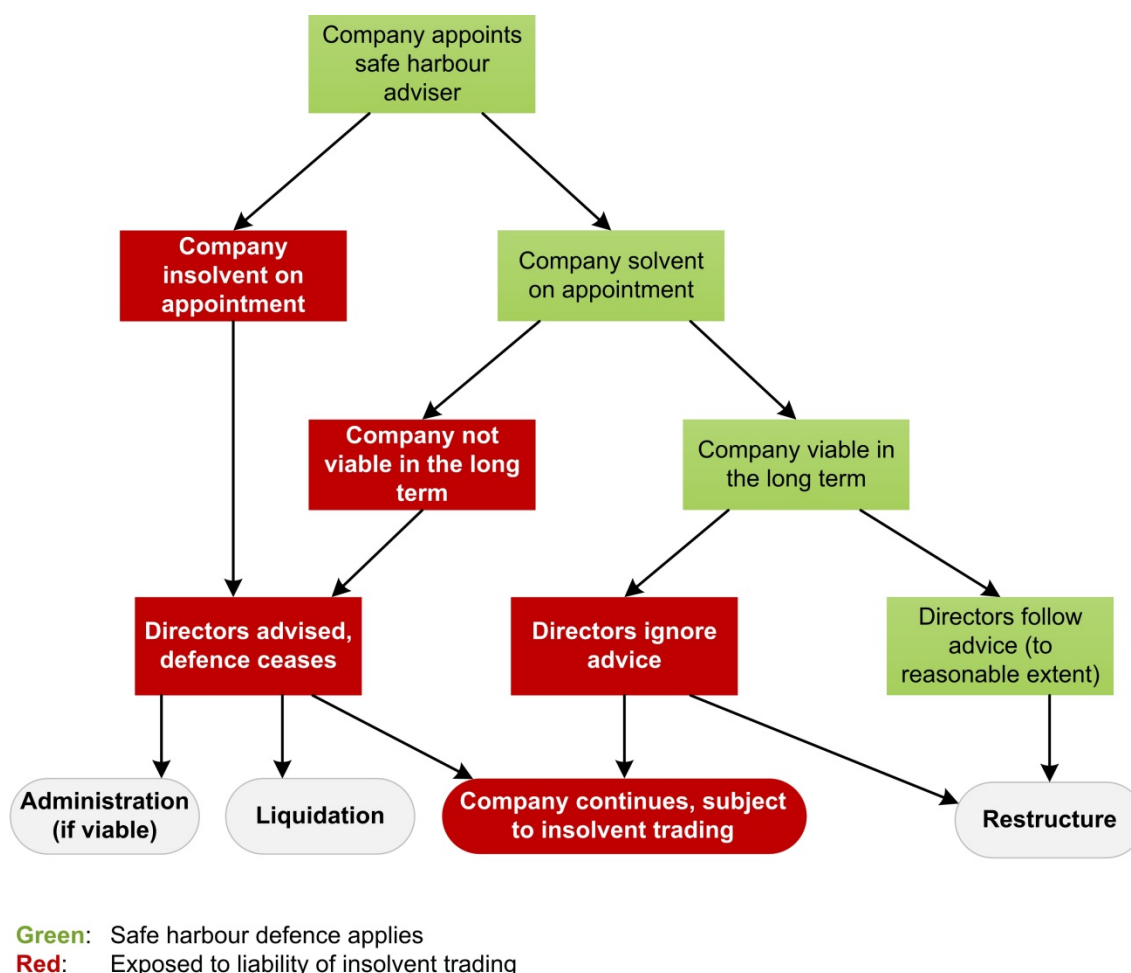
For so long as advice is being given about steps to take, supported by information including current financial information and financial forecasts, which will reasonably likely deliver solvency at a future point in time, and the person is implementing those steps (or facilitating their implementation) as and when appropriate, it is intended that the defence be available.

If the advice is that agreement on a key factor is unlikely to be forthcoming and no alternative step is available, so that the future solvency of the company is unclear, then the defence ceases to be available. (sub. DR46, attachment 1, p. 8)

This does not mean that the directors are obligated to implement the advice exactly as given. Instead, the defence will still be available as long as the directors *took reasonable steps to implement the advice and had documented, sound reasons for departing from it*.

Overall, the Commission considers that the application of the safeguards should operate to ensure that safe harbour provides an opportunity for restructure while minimising opportunities for abuse. Figure 14.1 depicts a timeline of seeking and receiving safe harbour advice, and when the defence would apply during the process of restructuring.

Figure 14.1 The operation of the safe harbour defence



While the Commission does not propose any fixed time frames, there should be some limits to the period and availability of advice. As with voluntary administration, restructuring should not be endless and should not be used to indefinitely and repeatedly

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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’. Some safeguards are required to prevent this. First, the advice must be *proximate to a specific circumstance of financial difficulty*. Second, the defence should be subject to *general anti-avoidance provisions* based on those applied under tax law. Together, these requirements should ensure that the safe harbour defence is only used during genuine restructuring attempts (and has the effect of providing some protection from liability). While not setting specified time periods, the anti-avoidance provisions should also be used to target repeated use of safe harbour within a short period — whether through ill-intent or serial ineptitude.

Indeed, safe harbour should not be seen as a ‘free pass’ for directors to wash their hands of any liability. Some participants suggested extending the application of the defence to matters outside of s588G, and the Corporations Act — for example both the Business Law Section of the Law Council of Australia (sub. DR55) and the AICD (sub. DR43) suggested that the defence apply to tax liabilities, specifically the ATO’s Director Penalty Notice regime. The Commission disagrees, and considers that *the defence should only apply to insolvent trading*, as its purpose is to remove distorted incentives arising from the fear of insolvent trading liability, and thus improve opportunities for ongoing solvency or restructure. It should not be used to excuse directors from other existing regulatory requirements.<sup>63</sup>

One exception to this is that safe harbour should also apply as a *prima facie defence to an unfair preference claim*, provided the sale that occurred was advised in safe harbour. The extent of the protections outlined above, along with the stated purpose to attempt to restructure the company, should mean that any transactions that follow the restructuring advice are in the overall best interests of the company. The Business Law Section of the Law Council of Australia (sub. DR55, p. 4) suggested that a similar defence could operate instead of pre-positioned sales. The Commission agrees, but sees this defence as just one option to give effect to pre-positioned sales (below).

The Commission does not consider that there is a need to ‘lower the bar’ to prove insolvent trading if the advice is not followed (or the defence not made out in some other way). However, the fact that the directors have sought advice (and potentially appointed an adviser) but not pursued any further action, is *prima facie* evidence that they had knowledge of the company’s troubled financial status.

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<sup>63</sup> Of course, the appointment of a safe harbour adviser could still be used as a component in existing defences. For example, it could indicate that the director had taken ‘all reasonable steps’ to ensure that the company paid the amount outstanding, appointing an administrator or winding up the company depending on the advice received — that is, fulfilled defences which can negate liability for a director penalty (ATO 2013a).



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#### RECOMMENDATION 14.2

The *Corporations Act 2001* (Cth) should be amended to allow for a safe harbour defence to insolvent trading. The defence would only be available when:

- directors of a company have made, and documented, a conscious decision to appoint a safe harbour adviser with a view to constructing a plan to turnaround the company
- the adviser was presented with proper books and records upon appointment, and can certify that the company was solvent at the time of appointment
- the adviser is registered and has at least 5 years' experience as an insolvency and turnaround practitioner
- directors are able to demonstrate that they took all reasonable steps to pursue restructuring
- the advice must be proximate to a specific circumstance of financial difficulty, and subject to general anti-avoidance provisions to prevent repeated use of safe harbour within a short period.

The defence would not attach to any particular decision and instead would cover the running of the business and any restructuring actions from the time of appointment until the conclusion of (reasonable) implementation of the advice.

- If the adviser forms the opinion that restructure into any form of viable business or businesses is not possible, they are under a duty to terminate the safe harbour period and advise the directors that a formal insolvency process should commence.

The safe harbour adviser may only be appointed in a subsequent insolvency process with leave of the court.

### **Pre-positioned sales**

Directors may negotiate for a sale of the company, or parts of it, that is concluded either immediately before, or during, a formal insolvency process. Such sales could become more common as a result of advice given under the safe harbour defence. This could create a process analogous to the current practice in the United Kingdom (box 14.2) 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' as distinct from pre-packs, which they argued should be reviewed by an insolvency practitioner:

For a number of reasons, including independence ... 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

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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)

### Box 14.2 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. However, the United Kingdom's Graham Review of pre-packs noted:

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 just 3 per cent of insolvencies and less than 0.25 per cent of all exits (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)

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).

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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 UK 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.<sup>64</sup> 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)

The Commission shares ARITA's concerns regarding the lack of transparency in the UK system, and the potential impact this could have in facilitating 'phoenix' activity (chapter 15). However, the added independence from using a pre-positioning system would also introduce administrative costs and delays associated with the review process, add 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 particular value in cases involving related parties.<sup>65</sup>

However, not all related party transactions are necessarily designed to avoid liability. In some instances a related party may simply be the most appropriate purchaser available for the business — a director striking out on their own, a supplier, senior management team member or a large shareholder or creditor acquiring a business of interest to them.

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. Current competition laws relating to mergers and acquisitions that could substantially lessen competition in a market would continue to apply. There are also 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

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<sup>64</sup> The Commission notes that one exception would be a registered safe harbour adviser where the sale is a result of the safe harbour advice. As discussed above, in that instance the safe harbour adviser may continue with leave of the court.

<sup>65</sup> 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).

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related party transactions (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 some transactions to become 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 as 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. The external administrator would be obliged to evidence that they had checked the transaction against the existing regulatory requirements.

In the draft report, the Commission's recommended approach to pre-positioned sales was framed in terms of the safe harbour process, and delineated based on the involvement of related parties. Feedback from participants focused on the relationship with safe harbour, the balance between certainty of the transaction and independence of the administrator and the connection with related parties.

To be clear, the Commission's revised recommendation for pre-positioned sales interacts with, *but is not limited to*, the use of the safe harbour defence. The Commission envisages that pre-positioned sales may occur in the normal course of business, and need not involve a safe harbour adviser. For example, a sale may be negotiated for the company and effected prior to the appointment of an external administrator, or it could be negotiated prior to the appointment of an external administrator but effected post appointment.

Transactions in the first scenario would be governed by existing general directors' duties (ss180-4 of the Act). While administrators would not be required to specifically review such sales, there would still be scope for the sales to be challenged on the normal grounds (including unfair preferences (s588FA), uncommercial transactions (s588FB) and unreasonable director-related transactions (s588FDA), among others).

To improve certainty under the second scenario, but maintain protections, reliance on the safe harbour defence (and all its safeguards noted above) should be available to allow a pre-positioned sale of all or part of a business that occurs entirely before a formal insolvency appointment to go ahead, unhindered by any challenges for 'uncommercial' sales (that is, voidable transactions broadly defined). The presence of an experienced, registered and independent safe harbour adviser with documented advice should be sufficient to protect against wrongdoing, while at the same time improving certainty for parties to the sale.

In relation to sales effected *after* the appointment of an external administrator, several participants — including ARITA (sub. DR 53), DibbsBarker (2015) and McGrathNicol (sub. DR60) — focused on the need for transparency around the sale. Broadly, the Commission agrees and considers that requirements should be added to s439A of the Act (governing administrators providing information to creditors) to report on the reason for, and terms of the sale. The information to be provided could be based on the disclosure

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requirements within the United Kingdom's Statement of Insolvency Practice 16 (UK SIP 16, ABRP (UK) 2013) which governs pre-packaged sales.

DibbsBarkers (2015) and McGrathNicol (sub. DR60) also suggested that the administrator should be satisfied that appropriate marketing efforts were undertaken and that the sale achieved the best price reasonably obtainable in the circumstances.

While these are important considerations, to strike a balance between expedience and certainty for the sale of businesses, and independent review aimed at preventing illegitimate transactions, the Commission reiterates its preference for 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). This delineation allows for the level of investigation (and therefore cost and delay) to be more tailored to the level of risk involved.

*If no related parties are involved*, there is a presumption that the sale should go ahead, unless the administrator can prove that the sale was not for an amount within a reasonable range around prevailing 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), or the sale would unduly impinge on the performance of the administrator's duties.<sup>66</sup> In these instances, to reduce the cost and delay of review, the law should be amended to allow administrators to rely on the documented pre-appointment sale process as evidence of the marketing and sale price.

*If any related parties are involved*, there is no presumption favouring sale and the administrator's examination continues as normal, including consideration of whether the company has already complied with the body of related party regulations discussed above.

As with pre-appointment sales, the safe harbour defence should also be applied to voidable transactions (but does not obviate the need for a check of related party requirements, instead providing evidence that goes to the arm's length nature of transactions).

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<sup>66</sup> DibbsBarker (sub. DR46, p. 5) provide an example of a sale where deferred consideration meant that the administrator was unable to carry on the business as a going concern and therefore needed to terminate the contract and sell the business for immediate payment.

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#### RECOMMENDATION 14.3

Provision should be made in the *Corporations Act 2001* (Cth) for ‘pre-positioned’ sales.

Where no related parties are involved, there should be a presumption of sale such that administrators can overturn sales only if they can prove that the sale was not for reasonable market value (in accordance with s420A of the Act), or if it would unduly impinge on the performance of the administrators’ duties. Administrators or liquidators should be allowed to rely on the pre-appointment sale process as evidence.

If sales are to related parties, there is no presumption favouring sale and the administrator’s or liquidator’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.

In both cases, s439A of the Act should be amended to include requirements to disclose information of the sale to creditors.

Where the sale (whether given effect before or after the insolvency appointment) is the result of advice received under the safe harbour defence, that defence should also apply against voidable transactions actions from administrators or liquidators.

### Pre-positioning for small companies

The options for restructure discussed above involve professional expertise and therefore incur costs reflecting this — the typical (median) voluntary administration (including the execution of a DOCA) costs \$60 000 (Wellard 2014).<sup>67</sup> In the UK, small businesses are the predominant users of the pre-pack system, with most pre-pack resulting in sale of the business for less than £100 000 (Crouch Amirbeaggi, sub.DR68, Graham 2014). While the Commission considers the regulatory safeguards around safe harbour are necessary, it acknowledges that the cost of an administrator or an experienced registered safe harbour adviser may be too high for some smaller businesses heading into financial difficulty. Such businesses may have little scope to restructure — they rely on a few assets and staff, and cannot separate elements to be sold off without damaging the ‘core’ business.

Crouch Armibeaggi suggested an Australian hybrid model that could avoid these costs, assuage creditors’ concerns, and present small to medium enterprises with a genuine option for restructure:

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<sup>67</sup> Wellard (2014) examined a random sample of 72 executed COAs effectuated between 1 August 2012 and 231 July 2013. He found that the average cost of a voluntary administration was \$54 670 and the average remuneration for a deed administrator (for a DOCA) was \$97 141. The median remuneration for a voluntary administrator was \$31 500, while for a deed administrator it was \$28 772. Given the average is more heavily skewed by any expensive outliers, median remuneration figures are more likely to be representative of the costs faced by small businesses undergoing formal restructuring.

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I suggest that any Australian version prepacks require [that] liquidators assisting directors with a pre-pack ... comply with an equivalent of section 420A of the Corporations Act 2001 (which requires a receiver to ensure market value is realised when selling assets).

If a liquidator's registration is on the line, creditors could be significantly more confident that appropriate advertising and direct marketing of the available assets of a small insolvent business was undertaken. (sub. DR68, p. 7)

With the sale of a small business, as with small liquidations, proportionality in risk management is key for the level of regulation. In particular, any requirements for adequate marketing should not be onerous, but sufficient to ensure a good process has been conducted and prevent clear wrongdoing (such as phoenix activity, chapter 15). As with larger pre-positioned sales, small pre-positioned sales should also require disclosure to creditors, on grounds similar to those outlined in United Kingdom's Statement of Insolvency Practice 16 (UK SIP 16).

In the Commission's view, concerns about the independence of liquidators could be alleviated by leveraging off the recommended 'small liquidation' process (chapter 15).

Specifically, a small pre-positioned sale would involve the company initiating the process in the same manner as a small liquidation — applying to ASIC for a 'next cab off the rank' insolvency practitioner and providing proper books and records. Thereafter the practitioner would facilitate the small pre-positioned sale, generally in line with the processes in recommendation 14.3. One exception would be that the protections of s420A of the Act should be read in the context of, and applied proportionately to, the small business for sale. This would apply to determinations of the relevant market for the sale, the amount of advertising effort required and judging if a reasonable price had been received — there should be no expectation that a small pre-positioned sale be the subject of an exhaustive national advertising campaign.

Such a process should provide an appropriate balance of an expedited (and therefore lower cost) sale with transparent processes conducted by independent practitioners — sufficiently protecting the interests of creditors and guarding against phoenix activity. This process could allow for a significantly smoother transition of assets (and employees) between businesses, than would require small companies to go through an expensive and time-consuming insolvency processes. Given its interaction with the Commission's proposed small liquidation process, it should only be implemented after the framework for small liquidations has begun operating.

As discussed in chapter 15, the Commission also considers that ASIC should publish a Regulatory Guide targeted at small businesses. A significant component of that guide should be directed at providing small business with a simple list of steps to follow in order to sell their business through a liquidator. This component should be modelled on the UK SIP 16. The production of such a guide will direct small businesses into the proper processes, improving overall compliance at a low cost.

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#### RECOMMENDATION 14.4

The small liquidation process detailed in recommendation 15.1 should include provision for small pre-positioned sales, consistent with recommendation 14.3.

In the context of small businesses, the requirements of s420A of the *Corporations Act 2001* (Cth), and investigations of related parties, should be applied proportionately in relation to determining the relevant market for the sale, advertising effort and reasonable price.

## 14.2 Facilitating restructure

While the options recommended above are intended to improve the timing of restructuring processes, there are still obstacles to their success once initiated. As discussed in chapter 13, 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 to 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.

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. Instead, s440B of the



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Corporations Act restricts only the rights of property lessors and owners and secured creditors, but not contracts more generally.

The commission's draft report recommended that ipso facto clauses 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 (CAMAC 2004) presented the arguments against changes to enforcement of ipso facto clauses:

- 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 2004, p. 72).

On balance, the Commission does not find the CAMAC arguments compelling. As Ferrier Hodgson identified, the existing regime already curtails secured creditors' rights (under s440B) and the personal liabilities imposed upon administrators also provide some protection to suppliers (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 appointed an external administrator. The test should not be confined to strict, formal termination of the contract, but also to invocation of clauses that render a previously workable contract onerous or plainly economically unviable. To combat the risk of 'drafting around' the

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moratorium, ARITA noted that many ipso facto clauses rely on ‘trigger events beyond formal insolvency’, and suggested:

... a statutory provision enabling an external administrator to apply to the court for an order restricting the termination of a contract where they believe a supplier is undermining the intent of [an ipso facto moratorium] and the termination of the contract is not in the best interests of the creditors of the company as a whole. (sub. DR53, p. 14)

While such a provision risks further increasing costs of administration through court involvement, on balance the Commission considers its availability alone would be of value to giving effect to the moratorium and improving the prospects of restructure.

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 or non-performance. 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 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, namely undue hardship.<sup>68</sup> Guidance notes to insolvency practitioners to encourage engagement with suppliers also appears to be a relatively simple way of avoiding potentially large costs.

Following the draft report, the Australian Institute of Credit Management (AICM) ‘strongly refuted’ any suspension of ipso facto clauses and argued that the behaviour of most creditors would ensure supply under the current arrangements:

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<sup>68</sup> In addition to initiating court action to terminate on grounds of undue hardship, suppliers should also be able to argue undue hardship as a sound basis for terminating a contract in the event that administrators take action to force the continued performance of the contract.

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... the vast majority of creditors will continue to supply during a period of Administration once it has been confirmed the Administrator will bear full liability ... The AICM also understands that a minor number of creditors may choose to withdraw supply or seek to change the terms. (sub. DR 62, p. 8)

The AICM also argued that retaining ipso facto clauses preserved a symmetrical power between administrators and suppliers, as administrators can choose to change suppliers (sub. DR 62, p. 8).

Despite this, most participants — including the Business Law Section of the Law Council of Australia (sub. DR55), PPB Advisory (sub. DR42), McGrathNicol (sub. DR60) and Arnold Bloch Leibler (sub. DR65) — supported the concept of an ipso facto moratorium. However, some expressed caution with their support. For example, the AICD noted that application to court may not be feasible for smaller businesses because of the costs of such an application, particularly where the business is already experiencing the undue hardship (sub. DR43, pp. 7–8). The AICD went on to advocate limited exceptions to the moratorium, modelled on the US Chapter 11 approach:

- where the trustee/assignee of the company is not able to fulfil the bargain originally offered by the company to the party; and
- where the contract is to provide debt financing or financial accommodation to the company (i.e. a lender is not required to provide further funds to the company). (sub. DR43, p. 8)

The first of the AICD's exceptions is likely to cover circumstances that already amount to a breach of contract. As the Commission noted in the draft report, its recommended moratorium would not change a party's ability to terminate a contract for any breach of payment or performance. In relation to the second exception, the availability of secured credit and the ability to appoint a receiver amounts to sufficient protection for (typically sophisticated) lenders.

The Commission considers that the ipso facto moratorium should apply to companies in voluntary administration or a scheme of arrangement — that is, where an independent practitioner is in control of the company and efforts are being made to restructure it. The change in recommendation 14.1 should also, in the long term, improve the likelihood that companies under administration can emerge in some viable form, and continue to honour the contracts in question.

In relation to the application of an ipso facto moratorium to other processes, as discussed above, the Commission now considers that 'safe harbour' should be implemented as a defence rather than a process. The confidential nature of safe harbour (at the time the adviser is appointed) obviates the need for an ipso facto moratorium at that time — creditors who are not directly involved in the restructure will likely be unaware that the company is in safe harbour, and thus would only terminate contracts on normal, non-performance grounds.

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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, and suppliers being paid for ongoing services has all but disappeared.

RECOMMENDATION 14.5

The *Corporations Act 2001* (Cth) should be amended such that *ipso facto* clauses that have the purpose of allowing termination of contracts solely due to an insolvency event are unenforceable if the company is in voluntary administration or the process of forming a scheme of arrangement. Amending legislation should make clear that the party experiencing the insolvency is in no way absolved of any other contractual obligations.

External administrators should be given the ability to apply to the Court to require continued performance of a contract where the Court is satisfied that the supplier is attempting to avoid this moratorium, and that the continuation of the contract is in the best interests of the creditors as a whole.

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.

## Improving the process for schemes of arrangement

As noted in chapter 13, 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.

Despite this cumbersome appearance, the Commission was informed that schemes tend to be used for large, complex corporate restructures. Most of those involved will be sophisticated parties who are familiar with such levels of process. Further, court supervision is appropriate to guard against any large parties unfairly oppressing relatively smaller creditors who may be caught up in the process. As such, the Commission considers that the current steps in the process are necessary given the context in which schemes are used.

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*.

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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)

Following the draft report, DibbsBarker (sub. DR46) and the Centre for Commercial and Property Law, Queensland, University of Technology (sub. DR64) also noted their in-principle support for a moratorium on creditor enforcement. ARITA noted that it removed the need for costly, and potentially damaging, concurrent appointments of administrators or liquidators — effectively for the purpose of accessing moratoriums — as occurred in the case of HIH Insurance (trans., p. 45). ARITA went on to note the importance of a moratorium to allow time for reconstruction arrangements to be formulated:

... one of the issues is that deeds have VAs to enable the process to be worked up; schemes don’t. So you don’t have this precursor administration in place like you do with a deed. So what schemes need is that precursor to enable that workup period to happen and the scheme to be put forward and the process to go forward. That would also have the ipso facto protection at that time to enable that moratorium and that workup for the scheme to happen. (trans., p. 44)

While the Commission considers that moratoriums will assist the formation of schemes, they could also lead to some abuse of schemes, and potentially negative impacts on some creditors. However, as Arnold Bloch Leibler (sub. DR65, p. 4) noted, the high level of court supervision should prevent any abuse of process.

#### RECOMMENDATION 14.6

The *Corporations Act 2001* (Cth) should be amended to create a moratorium on creditor enforcement actions during the formation of schemes of arrangement. This should be aligned with the approach used in voluntary administration.

Courts should also be given the explicit power to lift all or part of the moratorium in circumstances where its application would lead to unjust outcomes.

## **An insolvency panel?**

Arnold Bloch Leibler proposed the establishment of a ‘reconstruction panel’ that could be used to generally reduce the requirement for formal court processes across a range of routine insolvency matters:

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

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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 could essentially replace court oversight of schemes of arrangement, as well as a number of more administrative matters that currently go before the courts.

In the draft report, the Commission noted that it was attracted to options that reduced the costs that come with court involvement, but was 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)

Following the draft report, there was some qualified support from participants for the panel, but the Commission's post-draft report consultations suggest that insolvency matters are already dealt with in a relatively efficient matter by courts with corporations jurisdiction. In general, a registrar will act as a gatekeeper — they may hear more administrative matters themselves, or refer complex matters to a judge. The Commission was informed that, in both small and large jurisdictions, registrars will typically hear and conclude a matter within a week, and duty judges are available on the same day for more urgent matters. Reinforcing this, court data provided to the Commission indicates that registrars hear between 80 and 90 per cent of corporations matters (which are dominated by insolvency matters), and that these are typically dealt with in an expeditious manner.

Housing the matter within the court system also allows for the use of alternative dispute resolution, a process with a high success rate. Even where resolution is not achieved, the matter is referred back to a judge with the matters in contention refined to a few select issues. As Arnold Bloch Leibler themselves noted (sub. 23, p. 11), courts can already use independent expert witnesses (for example on matters of commercial, not legal, complexity) or require the parties to call experts to give evidence.

Given this range of existing processes, it appears to the Commission that any time savings on individual matters from the introduction of a panel would be marginal, at best. Constituting a panel to avoid conflicts of interest may also delay hearing of matters, a problem that is not an issue within courts. Finally, the recommendations of the panel may themselves be subject to appeal, further increasing the time taken.

Beyond the time saved per matter, an additional issue is the scope of matters that could be heard by the panel. These could be relatively administrative matters (overlapping with the role of registrars), or commercial issues (overlapping with expert witnesses). The

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Commission considers that when its reforms are taken as a whole, changes to the content of the insolvency laws — such as the introduction of small liquidations and transparency requirements — could substantially reduce the number of ‘churn’ matters that go before the courts, further reducing the potential utility of a panel.

Therefore the Commission considers that the introduction of a specialist reconstruction panel is not warranted at this time.

However, if the other reforms recommended by the Commission do not reduce workloads (and thus delays) within courts, there may be the need for such a panel at a future time. If the recommendations of the Commission’s Access to Justice Arrangements inquiry report (PC 2014a) in relation to improved data collection and reporting are adopted, there should be scope to examine trends in insolvency matters following the introduction of reforms. This examination should inform any future consideration of the need for a reconstruction panel.





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## 15 Corporate insolvency reforms

### Key points

- The Commission's proposed reforms aim 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 Assetless Administration Fund should be renamed the Public Interest Administration Fund, and the criteria to access it should be changed to reflect its new role of paying for small liquidations where the company lacks resources to pay for the processes required by law or ASIC. The increased funding required should be provided through a small increase in the annual fee for Australian Company Number renewals.
- In addition to existing requirements, company directors should be required to obtain a Director Identity Number to assist in enforcement activities, including those designed to detect and prevent illegal 'phoenix' activity. Improved guidance from ASIC could also assist in avoiding inadvertent instances of phoenix activity.
- Receivers should be subject to improved transparency requirements in situations where unsecured creditors form a committee for the purposes of engaging with the receiver.
- It is important that any changes to insolvency laws do not introduce opportunities for 'gaming' the system. As such, the Commission considers its proposals for the insolvency system, including both restructuring and winding up processes, as a package that should be implemented in its entirety.

Not all businesses will be candidates for, or successful users of, restructuring. For those businesses that fail, the focus of an efficient system should move towards a balance between expedient winding up and an orderly, robust 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.

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 also considered its proposals as they affect the overall insolvency framework — for restructuring, liquidation and associated areas.

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## 15.1 Reforming the winding up process

### 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).

These activities are not costless. But, as identified in chapter 13, 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 another 33 per cent of failed companies had estimated liabilities of between \$250 000 and \$1 million).<sup>69</sup> 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. This has required liquidators to cross-subsidise with other activities in order to remain profitable themselves — the Commission considers this neither efficient nor equitable.

A major component of these costs is the degree of investigation required. Current requirements are not proportionate to the size of the company, or the 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 [a broad category of insolvency practitioner, including liquidators] 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)

As identified in chapter 13, investigations by liquidators are not always followed up by the regulator (often with good reason). Indeed, in 2013-14, ASIC requested further information from external administrators in relation to around 10 per cent of the initial reports that identified possible misconduct, though this in part reflects the views of the administrators after further investigation (ASIC 2014e).

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<sup>69</sup> Appendix F contains further information on the characteristics of insolvent companies, including the proportion of insolvencies relating to small companies.

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In effect, a filtering process based on risk management is 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 based on the model developed by the Australian Restructuring Insolvency & Turnaround Association (ARITA, box 15.1). ARITA added further elements to its model after the Commission's draft report, including the use of internet-based communications with creditors, not requiring creditors to prove for 'small debts', and:

- There be a requirement for only one notice to call for proofs of debt and declare a dividend, including by way of a notice to the creditor of the amount detailed in the director's Report as to Affairs (RATA). The creditor would only need to lodge a claim if they dispute the RATA amount.
- No timeframe limit for payment (dividend must currently be paid within 2 months or process must start again)
- No separate requirement for notification of adjudication unless claim rejected in full or part
- Restriction on the ability to challenge the adjudication of a proof of debt through the Courts below a set threshold. (sub. DR53, pp. 16–7)

The Commission generally supports ARITA's model for small liquidations, 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 in a manner proportionate to the level of service provision.

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### Box 15.1 **ARITA's model for streamlined liquidations**

ARITA summarised their proposed streamlined liquidation process, and its difference from current liquidation processes as involving:

- 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. 23–24)

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).

Some participants raised concerns about the filtering mechanism proposed — a threshold of \$250 000 in liabilities. Specifically, both McGrathNicol (sub. DR60) and the Business Law Section of the Law Council of Australia (sub. DR55) were concerned that use of a threshold could lead to parties 'gaming' the system — that is manipulating their balance sheets in order to qualify for the small liquidation process. While a risk with any threshold,

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such gaming can be countered by requiring the (independently appointed) liquidator to verify that the company in question does qualify for the small liquidation process. Given the threshold relies on liabilities, verifying their true level should be a normal part of the liquidator's role. If the company does not qualify, the liquidator should be obliged to convert it to a full liquidation — thus negating any perceived benefits from manipulating the threshold. Limiting the threshold to liabilities to *unrelated* entities as suggested by ARITA (sub. DR53) also limits the scope for manipulation.

Following the draft report, ARITA also suggested an additional 'hurdle' for companies to access the small liquidation process that could reduce the risk of gaming:

ARITA strongly believes that a 'streamlined liquidation' needs to be based on a debtors' petition process where directors lodge a petition with ASIC together with a completed RATA [Report As To Affairs] and declaration that the company's liabilities are below \$250,000 (similar to that under a personal insolvency debt agreement under Part IX of the *Bankruptcy Act*). (sub. DR53, p. 16)

While the Commission notes that a RATA (or the ability to inspect the company's books) is already required in some circumstances, it considers that requiring those directors who seek to access small liquidation to approach the process 'with clean hands' should encourage good governance practices. Further, providing the liquidator with a summary of affairs upon appointment should assist in expediting the process.

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 small 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 — particularly 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)

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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. Following the draft report, ARITA supported appointment by rotation and noted that the independence it ensured would be important for creditors’ confidence in the process (sub. DR53, p. 15). The Commission considers that this independence should also allay concerns (as expressed by the Australian Bankers’ Association (sub. DR63)) of any increase in illegal phoenix activity. As noted below, phoenix activity is most often facilitated by liquidators who have a previous relationship with the directors.

Participants, including McGrathNicol (sub. DR60) and the AICM (sub. DR62), also raised concerns about the operation of the unfair preferences regime.<sup>70</sup> Specifically, a requirement that liquidators pursue potentially ‘unfair’ payments to creditors in the 6 months prior to insolvency can have a number of adverse effects, including:

- Discouraging active debt management by creditors who may be later ‘penalised’ with legal action simply for calling in their debt earlier than others. This could also impact on creditors’ willingness to engage in debt management with companies seeking to work out of financial difficulty.
- Given unfair preferences amounts are potentially recoverable, there is ‘an implicit expectation that liquidators have a duty to investigate and seek to recover such property. The relief to not pursue an action due to a lack of funds may be complicated by the availability of litigation funding’ (McGrathNicol, sub. DR60, p. 8).
- Due to this expectation, liquidators often feel compelled to pursue claims nearly regardless of their prospective net benefit.
- The pursuit of claims can cause fractious relations not only with the creditor that is subject of the litigation, but with other creditors who are concerned that their potential recoveries are being consumed by expensive legal costs.

It is apparent that the unfair preferences regime is not operating as intended. While it should also be subject to further detailed review, the Commission considers that scope exists to reconsider the balance between expediency and recovery as part of the implementation process for small liquidations. McGrathNicol (sub. DR60) advocated that unfair preferences should be abolished in a streamlined process. The Commission considers, however, that limits should be placed on the pursuit of unfair preferences amounts in small liquidation process, including:

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<sup>70</sup> The unfair preferences regime (s588FA of the Act) is one of a suite of voidable transactions (division 2 of Part 5.7B of the Act). Broadly, if a transaction in the six months prior to insolvency results in a creditor receiving more than they would if that debt were part of the normal winding up process, they are taken to have received an ‘unfair preference’ ahead of other creditors. A liquidator may seek a court order to recover some, or all, of the amount of the transaction.

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- limiting the period to which they apply to three months prior to insolvency;
  - limiting the ability to make a claim to material amounts — for example, amounts that are both at least one quarter of the company’s liabilities, and at least \$10 000; and
  - explicitly removing the duty on liquidators to pursue unfair preferences, unless the liquidator forms the view that there is clearly a net benefit to the action and it will not otherwise impede a satisfactory conclusion of the overall liquidation process.

These issues highlight that, in the long term, consideration should be given to streamlining requirements in insolvency more generally. This would be the case regardless of whether or not the Commission’s small liquidation process is implemented.

RECOMMENDATION 15.1

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 to unrelated parties of less than \$250 000.
- To access small liquidations, directors should be required to lodge a petition to the Australian Securities and Investments Commission (ASIC) and verify that their books and records are accurate.
- The primary role of the liquidator would be to ascertain the funds available to a reasonable extent, given a reduced timeframe. Requirements for meetings, reporting and investigations should be reduced accordingly.
- The pursuit of unfair preference claims should be limited to those within three months of insolvency and of material amounts. The duty to pursue unfair preferences should be explicitly removed unless there is a clear net benefit and it will not impede conclusion of the liquidation.
- Creditors would be able to opt out of the process and into a standard creditors’ voluntary liquidation, and ASIC would be able to initiate further investigation if it has concerns of illegality.

Liquidators for these processes would be drawn from a panel of providers selected by tender to ASIC. Panel membership would be for a period of up to five years, with ASIC able to conduct tenders at regular intervals to ensure that demand can be met.

ASIC should be empowered to hear complaints of practitioner misconduct and if the complaint is upheld, replace the liquidator. ASIC should be enabled to take disciplinary action, if warranted, against the discharged liquidator, including the suspension from participation in the panel or revocation of their registration.

The Commission also notes that the current Insolvency Law Reform Bill 2014 vests creditors with a degree of power that may be inconsistent with streamlined liquidation processes. It is the Commission’s intention that the streamlined reporting involved in the

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small liquidation process override the changes in the Insolvency Law Reform Bill 2014, provided the liquidation meets the criteria stipulated above.

### Funding small liquidations

The Commission is mindful that regulators in this area, particularly ASIC, need the appropriate resources to implement, enforce and monitor the necessary reforms. This also applies to those charged with regulatory functions. The Commission has noted in past inquiries the importance of regulators being adequately funded to perform their regulatory functions (PC 2013c).

The Assetless Administration Fund (the Fund) is a program within ASIC, established in 2006. It 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. A particular focus of the Fund is the curbing of illegal phoenix activity (ASIC 2014e). 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 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 [Assetless Administration Fund] 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 [AAF] 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 will involve a greater call on the Fund (where there are insufficient funds recovered to pay the liquidator). This was not the originally intended role for the Fund, and ASIC submitted that its current funding would not be adequate to perform this new role. ASIC went on to note that allowing the Fund to be accessed if they determine further investigation is warranted and ‘convert’ the small liquidation into a standard process was within the current objectives of the fund (sub. DR58, p. 15). The Commission acknowledges that this reform will require accompanying changes in the Fund, including increased funding in line with its new role. The Commission also considers that the Fund’s name should be changed to



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the Public Interest Administration Fund to reflect that investigations it funds are being undertaken primarily to protect the public interest, rather than for the benefit of creditors.

Anderson et al. (sub. DR40) and ARITA noted that the availability of funding could improve the likelihood of proper, and expedited, processes:

We believe that the implementation of a streamlined process may encourage SME directors to take pro-active action in relation to their financially distressed companies. The fact that the liquidator is proposed to be funded will also mean that directors of such companies will be able to secure the appointment of a registered liquidator. At present, many insolvent companies do not proceed to liquidation voluntarily because there are no funds in the company from which the liquidator may be paid. (sub. DR53, p. 16)

While some may argue that regulatory functions should in general be funded on a user-pays basis, in this context the direct user (the company being liquidated) almost by definition, is not guaranteed to be able to pay. Therefore, recognising a balance between efficient funding on a user-pays basis, and the presence of both public and private goods (enforcement of laws and returns to creditors most of whom, particularly in value terms, are companies themselves), the Commission considers that a small increase in the annual review fee for Australian Company Number renewals (but not on new applications) is an appropriately targeted source of the additional revenue that would be required. This not only operates as a form of ‘life insurance’ for companies to ensure their own liquidation is conducted according to minimum standards, but also benefits honest companies by ensuring a baseline of investigation is completed to detect any fraudulent activities that may exist within the broader group of liquidated companies.

While the data required to precisely estimate the additional funding that this would require was not available during this inquiry, ARITA submitted that (sub. DR73) they will be conducting research across the insolvency profession to estimate the difference between the current cost of liquidation and the anticipated cost of a streamlined small liquidation, to be completed in early 2016. In implementing the Commission’s recommendations, the Government may wish to build on this research through broad based and independent research of its own. The difference between the cost of full and small liquidations would form the final component required to estimate the initial additional funding required beyond the current amounts granted under the AAF.<sup>71</sup> After the small liquidation process has been operating for three years, the required funding can be determined through the natural iteration of the tender process.

The Commission notes that the Government’s current consultation paper on a proposed industry funding model for ASIC (The Treasury 2015b) and the capability review of ASIC (Frydenberg 2015) will together consider changes to the manner of funding ASIC. As noted above, the Commission considers its funding proposal for small liquidations is

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<sup>71</sup> In 2014-15 the AAF provided a total of \$3 126 830 in funding across 295 grants. The median grant was \$8250. In 2013-14 the total amount was \$3 118 737 (Commission calculations based on ASIC 2015a).

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consistent with user-pays principles and should proceed in addition to any changes that arise from broader consideration of ASIC's funding.

RECOMMENDATION 15.2

In instances of small liquidations where a liquidator is unable to recover funds to cover their own fee, and where the Australian Securities and Investments Commission (ASIC), is satisfied that the activities are not excessive, the liquidator should be able to apply for the balance of their fees to be paid through ASIC.

- The existing Assetless Administration Fund should be renamed the Public Interest Administration Fund and its objectives and funding modified to reflect this new function.
- To the extent that this requires additional funding, it should be raised by increasing the annual review fee for company renewals.

Funding should also be available from the Public Interest Administration Fund in instances where ASIC initiates further investigations beyond those required by the small liquidation process.

## 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 Australian Institute of Company Directors (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:<sup>72</sup>

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 business' premises, core pieces of factory plant, aircraft 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 13).

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<sup>72</sup> 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).

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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). 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 (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 15.2) 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 creditor’s 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.

In the draft report, the Commission proposed subjecting receivers to a duty to not cause unnecessary harm to the interests of creditors as a whole, and to subject actions outside the normal course of the debtor’s business to a simple majority vote of the remaining creditors.

With the exception of the AICM (sub. DR62), participants responded strongly against the Commission’s draft recommendation. Some — including the Australian Bankers’ Association (sub. DR63) and the Business Law Section of the Law Council of Australia (sub. DR55) — cited potential cost of credit concerns. Many others — including ARITA (sub. DR53), McGrathNicol (sub. DR60) and PPB Advisory (sub. DR42) — noted that the cost of identifying creditors and holding meetings and the uncertainty of the outcome if a receiver is prevented from selling the secured asset would make the recommendation unworkable.

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## Box 15.2 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 2008, 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 realisations 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 2008, p. 170)

The authors suggested two potential reasons for the increase in the costs of insolvency processes. 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), and 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. 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. For example, now that they are denied traditional receivership, secured creditors have used different means (pre-packs, discussed in chapter 14) to protect their return (ARITA sub. 31, p. 18).

Several participants also argued s420A of Corporations Act — which requires that receivers exercise 'all reasonable care' to sell the property at either market value, or at the 'best price that is reasonably obtainable' in the circumstances — is sufficient to protect creditors. Other relevant provisions include the ability for the Court or ASIC to act upon complaints and make orders against receivers (s423), the Court's power to fix a receiver's remuneration (s425), protections to ensure that a receiver does not interfere with a voluntary administration (ss 440B and 441D, among others) and the ability for the

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company or its creditors to challenge the validity of the receiver's appointment (s418A). Participants also informed the Commission that practice within the market tended to avoid the appointment of receivers — secured creditors are becoming wary of the financial costs and negative public perception that an appointment causes and the impact this may have on ongoing relations with other creditors.

Given the practical difficulties in implementation and apparent effectiveness of existing practices and protections, the Commission considers that there is insufficient evidence to proceed with its draft recommendation.

Nonetheless, the Commission heard of isolated incidents of banks appointing receivers under so-called 'constructed' default involving selective revaluation of property. While the Commission understands that this is not industrywide practice, it clearly can have substantial effects on individuals (McNamee, trans., pp. 66–70), leading to (rather than following from) corporate or personal insolvency and in several cases bankruptcy.

Such actions are the direct subject of a current Parliamentary Joint Committee on Corporations and Financial Services (PJC) inquiry into 'the impairment of customer loans', due to report in March 2016. While the cases brought to the PJC do not appear to have a systemic impact on the overall function of the insolvency system, such actions illustrate that there may be a need to tighten the regulatory regime surrounding receivership in order to ensure it operates as originally intended — that is, to protect the security in the event of (imminent) default.

The Commission considers that there is a need, beyond the current PJC inquiry, for a specific review of the role, powers and practices of receivers to ensure that they are operating in a manner that protects the secured credit while minimising the opportunity for strategic manipulation (for example of lending portfolios).

#### RECOMMENDATION 15.3

The Australian Government should instigate an independent review, to report by 30 June 2017, of the relevant parts of the *Corporations Act 2001* (Cth), and the practices of receivers in the market, with a view to ensuring that:

- The primary role of the receiver should be to protect the value of the property that is the subject of the secured credit.
- The focus should be on the performance of individual loans. The appointment of receivers should not be used as a mechanism to manage lenders' portfolios.
- If there is a substantial group of unsecured creditors affected by the receivership, the receiver should have consideration of the impact of their actions upon the overall wellbeing or insolvency of the company.

Another issue raised with the Commission was the costs incurred by receivers in performing their roles, and that challenges to receivers' fees were a common cause of legal

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action. For example, Crouch Amirbeaggi submitted that the current model was an ‘inherently unfair structure’ and that:

... if a secured creditor will be paid in full, there is simply no incentive for them to closely scrutinize the process or costs of their receiver.

This creates a risk that the costs of realization can be excessive. The stakeholders will normally be incapable of challenging the process due to the inherent barrier of costs in litigation. (sub. DR68, p. 10)

In consultation with Courts with insolvency jurisdiction, the Commission was told that commonly, a lack of effective communication between the receiver and unsecured creditors was the dominant cause of legal action — creditors had no idea of the reasoning behind what may be fully justified actions, how much work the actions would require and their cost.

To remedy this, the Commission broadly agrees with the submission of Crouch Amirbeaggi (sub. DR68) that improved communication is warranted. Specifically, receivers should be required (under statute) to provide basic information to creditors in a manner similar to the obligations of a liquidator to a committee of inspection. The information should include:

- a description of the proposed process
- the results of the sale process
- details of proposed and actual costs and disbursements.

Again in line with the requirements upon liquidators, receivers should be required to ‘have regard’ to the views of certain stakeholders. This does not necessarily mean that they are bound by the stakeholders’ views, but simply that they must give them consideration and be able to explain any deviations.

The Commission is mindful that the receiver’s role, unlike an administrator or liquidator, is to act between the company and the secured creditor. At present, they do not necessarily interact with the broader creditor base. As such, to reduce costs in the receivership process, receivers should not be required to perform any searches, advertising or due diligence to actively contact creditors. Instead, the informational requirements listed above should only apply where creditors have formed a committee, that committee has contacted the receiver and notified the receiver that they wish to be informed.

To improve accountability, these committees should be specifically empowered to apply to the Court to seek relief in relation to the fees, but not actions (including sales) of the receiver. In the Commission’s view, the recommended increases in transparency should improve understanding amongst creditors of the requirements upon receivers and actually reduce the amount of claims lodged in Court.

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#### RECOMMENDATION 15.4

The *Corporations Act 2001* (Cth) (the Act) should be amended such that where the stakeholders in a receivership (that is, unsecured creditors including employees and government authorities such as the Australian Taxation Office) form a committee of inspection and notify the receiver, that committee should have the right to basic information regarding the receivership process. This should include, but not be limited to:

- a description of the proposed process
- the results of the sale process
- details of proposed and actual costs and disbursements.

Receivers should be compelled to have regard to the views of the committee in a similar manner to liquidators under s479 of the Act. Considerations directly relating to protecting the value of the security should override any views of the committee.

The committee should have standing under s425 of the Act to apply to the Court to seek relief in relation to the fees (but not actions) of the receiver.

## 15.2 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.<sup>73</sup>

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

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<sup>73</sup> 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 2015b), Denmark and Germany, though differing payment structures and ranking of creditors applies between countries (Johnson 2006)

the employee as a creditor in the liquidation and attempts to recover its outlay through 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).<sup>74</sup>

The FEG is the latest iteration of an Australian Government employee entitlement scheme. It 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**

	<i>Employee Entitlements Support Scheme (January 2000 – September 2001) <sup>a</sup></i>	<i>General Employee Entitlements and Redundancy Scheme (GEERS) — initial form (September 2001 - 2006)</i>	<i>GEERS as amended (2006 - December 2012)</i>	<i>Fair Entitlements Guarantee (December 2012 - )</i>
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 <sup>b</sup>

<sup>a</sup> Total payments under the EESS were capped at 29 weeks' pay, maximum overall amount \$20 000. <sup>b</sup> Amendments are currently before the Australian Parliament to cap redundancy payments at 16 weeks.

Source: Department of Employment (2014)

<sup>74</sup> 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. That is, the property cannot be sold without the creditor's charge attached (unless the creditor consents otherwise). A fixed charge 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).



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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 other forms of insurance, the provision of a safety net creates a ‘moral hazard’ risk as the parties involved no longer directly face the incentives and costs 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 if 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).

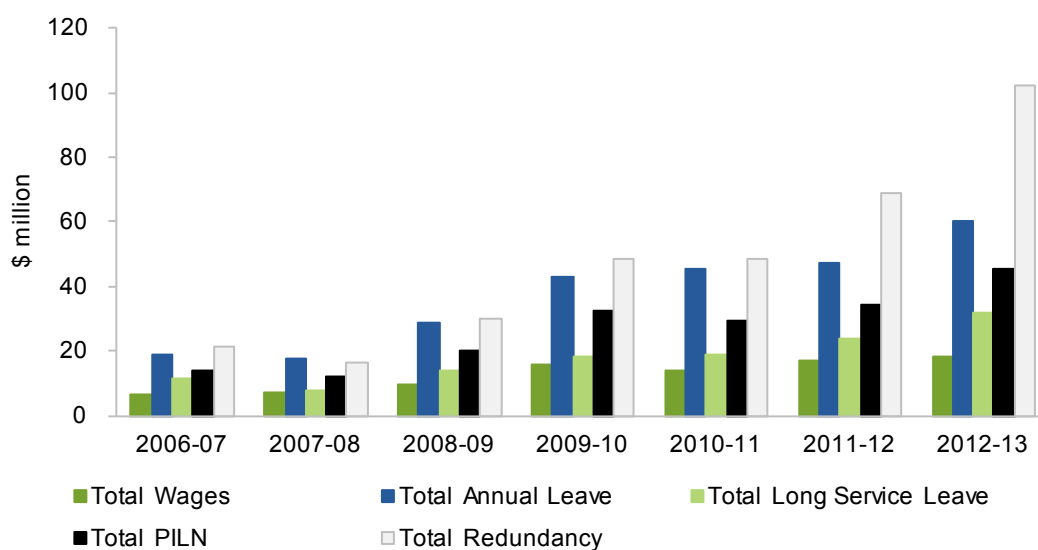
Similarly there is a risk that employees may not advocate thorough investigations by liquidators, and at the margin, the safety net could affect the views of directors and employees on the desirability of entering liquidation.

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 (possibly due to increased awareness of the scheme).
- The proportion of workplace agreements that provide a total maximum redundancy payment of more than 16 weeks increased from 23 per cent in 2011 (quarter 1) to 32 per cent in 2014 (quarter 3) — some employers could be 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 payments to claimants accounted 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**<sup>a</sup>



<sup>a</sup> 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).

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.

### 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

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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 2014e, 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 (appendix F).

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 associated with the actions of company directors.

To improve the Australian Government's standing and overall recoveries, Wellard (2013, pp. 5–6) suggested amendments to the insolvent trading provisions (s588G(1A)) of the Corporations Act. Specifically, the list of deemed 'debts incurred' during the insolvent trading period could include accrual of employee entitlements. Further, s560 of the Act could be amended 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:

... 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 then Department of Education, Employment and Workplace Relation'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.

In the draft report, the Commission recommended that, given the returns from the Active Creditor Pilot, it become a permanent part of the FEG scheme. In line with this, as part of the 2015 Budget, the Government announced that it:

... will provide \$11.5 million over two years from 2015-16 to undertake a two year trial of funding litigation activities to improve the recovery of employment entitlements advanced under the Fair Entitlements Guarantee (FEG) scheme. The effectiveness of the trial in achieving additional recovery will be reviewed in 2017. (Australian Government 2015a, p. 82)

Subsequently, the Fair Entitlement Recovery Programme was launched on 1 July 2015, to operate for an initial period of two years (Department of Employment 2015a). The Programme allows liquidators to apply for litigation funding to pursue recoveries which they otherwise would not have the financial resources to undertake.

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## There are other benefits in retaining the scheme

While there are concerns around FEG, particularly regarding moral hazard issues, the counterfactual is a world of ad hoc government responses, 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 or Commonwealth 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).

As with all policies, particularly those involving the expenditure of public funds, the Commission considers the performance of the scheme should be reviewed periodically (ideally every five years), commencing in 2021. Such a review should consider the impact of the currently proposed limits to redundancy payments, as well as further legislative amendments to the Corporations Act (as identified above) that could improve the Australian Government's standing as a creditor.

### RECOMMENDATION 15.5

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. As part of this, consideration should be given to amendments to the *Corporations Act 2001* (Cth) to allow the Commonwealth to play a more active role as a creditor.

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## Phoenix activity

An associated issue that contributes to the moral hazard that 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 Commonwealth through the FEG and 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 15.3 describes an example of the methods used in illegal phoenix activity.

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 engaging in phoenix activity through liquidation every year, with the lower bound likely to be the more reliable estimate,<sup>75</sup> to an ATO estimate of a total of 6000 phoenix companies operating in Australia in 2011 (Shorten 2011). The costs of illegal phoenix activity have been estimated to range from nearly \$1.8 billion to nearly \$3.2 billion per annum (table 15.3).

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<sup>75</sup> 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 or more directors previously involved with a liquidated entity and 20 per cent had directors who were associated with two or more previous liquidations (Ferguson 2010; PwC 2012). Not all directors of previously failed entities will have been engaging in illegal phoenix activity — some will have undertaken genuine restructures, been the victim of broader economic circumstances, or simply guilty of poor management rather than any illegality. As such, the lower figure, equating to 2040 liquidated companies, is likely to be a more accurate proxy for phoenix activity.

### Box 15.3 Structuring illegal phoenix activity

As identified by the ATO, 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)

Some contended that these costs are overestimates of intentional illegal phoenix behaviour:

... the 6000 figure grossly overstates illegal phoenix behaviour and instead accidentally includes legitimate related party restructures.

With respect to PwC, it cannot be reconciled with the 2001-02 ASIC annual report which suggests, 1.6% of liquidator complaints (194 complaints) received related to phoenix activity and the ATO's view that it finalised 124 phoenix cases in 2009 ... (Crouch Amirbeaggi, sub. DR68, p. 8)

**Table 15.2 The potential costs of phoenix activity<sup>a</sup>**

\$ millions, based on activity in 2009-10

	<i>Lower bound</i>	<i>Upper Bound</i>
Costs to employees	191	655
Costs to business	992	1 925
Cost to government revenue	601	611
<b>Total impact</b>	<b>1 784</b>	<b>3 191</b>

<sup>a</sup> As modelled by Pricewaterhouse Coopers.

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:

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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)

Whatever the direct costs, 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.

Any moves towards expediting insolvency should therefore consider the potential for unintentionally facilitating phoenix activity. However, overzealous regulation in this sphere runs the risk of creating excessive penalties for those who 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 2015b).<sup>76</sup>

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.

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<sup>76</sup> 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.

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## Identification of directors

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:

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.

Following the draft report, there was broad support from participants for the introduction of a DIN. There was even support from those who stand to be regulated — with the Australian Institute of Company Directors reporting that two-thirds of the 225 respondent directors to their survey on the matter supported a DIN (sub. DR43, p. 9). Of those who disagreed, their main reasons for concern related to more information on the cost and benefits, the increased administrative burden on directors, and that 'rogues' would find a way to work around the system (sub. DR43, p. 9).



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DINs will not be a ‘magic bullet’ that will eliminate all phoenix activity. Even with director identification and proved offences,<sup>77</sup> sophisticated and legally astute directors may structure 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<sup>78</sup> (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.

Implementing a DIN would involve a once-off online registration — a 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 provided 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’ education form to ensure that directors are aware of the duties and responsibilities that come with their positions. The information relating to the history of a DIN should be publicly available through ASIC.

ASIC (sub. DR58, p. 16) raised some concerns about the cost of implementing the DIN. However the Commission notes that the identity check could be completed online, and the DIN could be instituted as a marginal addition onto other regulatory requirements (for example in relation to Australian Business Numbers). As the AICD (sub. DR43, p. 8) submitted, ASIC should be provided with adequate funding to implement and monitor the regime. As an alternative, if ASIC is unable to implement a simple online DIN process, the Australian Business Register (sub. DR51) noted existing links between business and company registration processes that could be used to implement a DIN. These linkages should be considered in evaluating the most efficient manner of implementing and maintaining a DIN register.

The benefits, in terms of even a small reduction in illegal phoenix activity are potentially quite large (ASIC, sub. DR58, p. 15). Further, the use of DINs should make tracking directors simpler for administrators and liquidators, reducing the time and thus cost of insolvency processes.

Therefore, the Commission is confident that the introduction of a DIN is likely to be of significant net benefit to the community as a whole. Indeed, as the Australian Business Register (sub. DR51) submitted, the DIN could be used to link with other existing databases, to identify those businesses involving directors with a history of repeated insolvencies. This information could be used for ‘early intervention’ either in compliance

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<sup>77</sup> 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.

<sup>78</sup> (2009) 77 NSWLR 110.

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and enforcement or in providing targeted assistance (particularly education of responsibilities).

Another issue that arose after the draft report was how the DIN would fit with existing requirements upon directors. The Governance Institute advocated that the DIN would *replace* the existing requirements, reducing the risk of identity theft which they argued arises largely from the provision of birth date and place details and residential addresses (box 15.4).

#### **Box 15.4 The Governance Institute's model for an 'officeholder ID'**

The Governance Institute expressed support for the Commission's proposed DIN, and noted the similarities to a model they had previously suggested. Their model focused on concerns relating to existing publicly available information that directors are required to disclose:

... the open publication of birthdates and birth places of officeholders serves no useful purpose other than for persons with criminal intent. In this world of increasingly faceless transactions, birthdates have unfortunately become by default the first form of identity check by banks, telecommunications companies and other institutions to ascertain that they are communicating with an authorised person ... [publishing this information] is fraught with risk and a significant magnet for cyber-criminals. (sub. DR41, p. 7)

The Governance Institute went on to outline the use of an ID for each officeholder, noting that this would replace the existing public information, and that it would:

- ensure that the regulator continued to hold all of the personal information required to correctly identify an officeholder and their connection to any particular company or companies (including legacy information)
- remove the risk of identity theft which is currently posed by the public display of personal information of officeholders, given that identity theft is facilitated greatly by the provision of date of birth, place of birth, full and former names and residential address ...

Other parties are also interested in identifying and at times locating particular officeholders, as they seek to assess who has an interest in particular companies. Such third parties include the media, lawyers, banks and other creditors, liquidators and real estate firms. The use of an officeholder ID would assist this, as it would assist any individual seeking to locate an officeholder, as the ID held by the officeholder would reveal all of the companies with which they are involved ...

We also support the need for a mechanism to be publicly available in order to serve documents on officeholders. If an officeholder ID is used, there would need to be an obligation on each officeholder to provide a service address. However, the public generally does not need access to the residential address of officeholders. (sub. DR41, pp. 7–8)

Others strongly disagreed with this suggestion. The Media, Entertainment and Arts Alliance argued that the existing information had important uses in journalism (including preventing identification errors in cases of potential defamation) that supported transparency in corporate governance:

The system has worked perfectly well for decades. Imposing impediments on its use now is a backward step that undermines prudent, responsible corporate behaviour and replaces it with an anonymous system hidden from view.

Any barrier to journalists carrying out their duty in legitimately scrutinising people holding positions of trust and power would be a backward step. (sub. DR69, p. 4)

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Professor Anderson et al., whose original submission advocated for a DIN, urged the Commission to consider current publicly available information as a separate issue to the DIN, which is focused on deterrence and enforcement (sub. DR67).

To be specific, the Commission's proposed DIN should be implemented *in addition to* existing directors' requirements (which should continue to be available under existing arrangements). The focus of the DIN on the role of liquidators and the potential reduction in phoenix activity are matters that have been considered within the scope of this inquiry. The broader issues of corporate governance, largely affecting ongoing companies (not just those setting up or closing), are beyond the scope of this inquiry and require separate consideration.

#### RECOMMENDATION 15.6

In addition to existing requirements for directors, section 117 of the *Corporations Act 2001* (Cth) should be amended to require that, at the time of company registration, 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 identity proof (based on the personal identification requirements for opening a bank account), 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 DINs should 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.

There should be no lessening of the existing recording of, and means of accessing, director information.

### Recovering funds within corporate groups

As noted above (box 15.3), phoenix activity can be undertaken within large, complex corporate groups. In this context, a subsidiary company, such as a labour hire company can have its assets transferred and be liquidated, while the overall group continues business as usual, free of the subsidiary's liabilities.

One option for reducing the incentive to undertake phoenix activity, and to increase the ability to recover funds for creditors and authorities, would be to draw funds from elsewhere within the corporate group, or 'pierce the corporate veil' (the legal separation between a company and its shareholders). Within corporate groups, the owners may be in fact the same, but their liability is limited with respect to each company, as they are all

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considered separate legal entities. In general, the existence of the corporate veil encourages shareholders to invest in companies by limiting their liability, and is seen as playing an important role in the development of large enterprises, and as a fundamental element to the nature (and benefits of) the company structure.

Despite this importance, there are currently circumstances in Australia where governments or courts have decided that it is warranted to pierce the veil:

... s588V of the *Corporations Act 2001* (Cth) provides that in limited circumstances holding companies can be liable for the insolvent trading of their subsidiaries. The Act also provides<sup>5</sup> for pooling of the assets of insolvent companies within corporate groups ... In addition, the courts may pierce the veil if the corporate form has been used for fraud, to shield the parent company from an existing legal obligation (the 'sham/façade' basis), or for corporate groups if the level of control is so complete that the parent company is deemed to be directly responsible for the activities of the subsidiary. A controlling company can also find itself characterised as a being in the same position as a director where the controlled company is accustomed to act according to its instructions or wishes, resulting in liability for director-type breaches of the Act. (Anderson et al., sub. DR 40, pp. 2–3)

Legislation in other jurisdictions goes further. Legislation in both New Zealand and Ireland allows courts to make both pooling (the combining of corporate group assets where each of the companies is being wound up) and contribution (requiring a solvent company within a group to contribute to the debts of an insolvent one) orders. Both jurisdictions subject the issuing of orders to several similar, but not identical, conditions. Broadly, these limit orders to circumstances where it would be 'just and equitable' to do so, having regard to matters such as:

- the extent to which the (parent) companies took part in the management of the other companies
- the conduct towards creditors
- the extent to which the liquidation in question was caused by the actions of any of the other companies in the group, and
- the extent to which the businesses of the companies have been combined in practice (Anderson et al., sub. DR40).

While allowing contribution orders may seem appealing as a means of providing wronged creditors with access to previously unattainable funds, it is important to remember that the solvent companies within the groups have obligations to their own creditors. In recognition of this, the law in Ireland includes consideration of the effect of the order on the creditors of the related company (Anderson et al., sub. DR40, p. 7).

In both countries, in addition to having to pass several hurdles, the orders are subject to judicial discretion. The orders are also relatively rare, potentially due to holding companies settling cases before they reach court (Anderson, trans., p. 10). While information on such settlements is typically confidential by nature, the existence of the laws provides a credible threat for liquidators (and authorities) in dealing with holding companies.

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The models in New Zealand and Ireland appear attractive as they are balanced in such a way that they do not undermine the fundamental nature of the company, instead only allowing access to funds from elsewhere in the corporate group in circumstances when, in practice, the related companies in question are not truly separate from the company in liquidation.

The introduction of a DIN is likely to expedite liquidation processes (as tracking of directors becomes simpler) as well as improving the enforcement of existing laws. Conversely, introducing a model based on those in New Zealand and Ireland improves enforcement, but only through the addition of further court action, potentially lengthening the liquidation process (though with sound reason). Additionally, such laws require a delicate balance between preserving the nature of the corporate form and being able to pierce it when the practical situation clearly suggests it is warranted.

The Commission considers that such a reform is worthy of further investigation. However, such matters are more appropriately dealt with in the context of specific consideration of the enforcement options targeted at addressing illegal phoenix activity rather than this inquiry's focus on the efficiency of the insolvency system.

### Education can assist small businesses

In the course of this inquiry the Commission heard from several participants — including Associate Professor Anderson (trans., p. 7) and ARITA (trans., p. 36) — of the conduct of certain pre-insolvency advisers whose methods may be strictly legal, but result in companies being 'stripped' such that directors will not face insolvent trading claims but can deny funds to creditors and in some instances lead to phoenix behaviour.

As Crouch Amirbeaggi submitted, small business owners with little knowledge of insolvency practices may be susceptible to such advice, and find that they have been party to the phoenixing of their company:

What is prevalent in the industry today is approximately 20 pre insolvency experts who call all 7500 small companies as soon as they hit the Court winding up list to offer phoenix solutions with varying legitimacy.

Desperate directors with little or no corporate law experience commonly fall for slick sales guys' kind words and promises of a new start. ... the mums and dads often pay large sums for services that do not provide any benefit. They are becoming victims of unscrupulous pre insolvency sharks. (sub. DR68, pp. 8–9)

Generally, there is an obligation on professional associations to ensure that their practitioners' behaviour is appropriate in order to uphold the profession's overall reputation. In this context, the Commission notes that, in line with other professional bodies such as the Chartered Accountants Australia and New Zealand and CPA Australia, ARITA already undertakes significant activity in educating (through courses and publishing its Code of Professional Practice), and disciplining its members. ARITA (ARITA 2014b) also intends to review its current discipline system in 2016 to introduce

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both formal and informal dispute resolution involving independent third parties. However, these processes only apply to their membership, which is not mandatory. Further, while registration (and thus involvement of ASIC as regulator) is required for the performance of certain tasks such as administration and liquidation, this does not cover the period before formal insolvency appointments. As such, there is a ‘gap’ in the ability to certify the professionalism of providers. Unscrupulous practitioners operating in this ‘gap’ could operate in a way that harms small businesses and their creditors.

Rather than attempt to regulate to cover any form of business advice (and potentially raise costs or reduce competition in the market), an alternative is to inform potential clients so that they can avoid engaging ‘sharp’ operators. In this context, Crouch Amirbeaggi advocated that ASIC produce a Regulatory Guide to assist and educate small businesses of any ‘alternative legitimate restructure practice’ (sub. DR68, p. 9). Informing small business of the legitimate options for restructure and exit could reduce inadvertent phoenix behaviour in a relatively low cost manner. This could also increase return to creditors, potentially increase overall levels of governance and expedite the liquidation process (by reducing the extent of investigation required if an insolvency appointment eventuates).

As noted in chapter 14, this guide should cover the process for small businesses to undertake a legitimate pre-positioned sale. For ease of use, it should do so in a simple ‘checklist’ manner. In this respect, the United Kingdom’s Statement of Insolvency Practice 16 (ABRP (UK) 2013) provides a model used to facilitate best practice when undertaking a ‘pre-pack’ sale.

ASIC already publishes significant amounts of information on its website — including an insolvency guide for directors, a guide for small business directors and information on closing a small business. However, this information is dispersed across the ASIC website, covering a range of specific and sometimes isolated topics. It is not consolidated in a meaningful ‘how to’ manner targeted at small business owners facing financial difficulty.

The Commission notes that the adoption of its package of recommendations would result in significant changes of particular relevance to small businesses. The Commission considers that — following the implementation of reforms to corporate insolvency — it would be timely for ASIC to produce a Regulatory Guide aimed at providing a clear process for the directors of small businesses in financial difficulty to follow.

In producing the guide, ASIC should consult with the insolvency and legal professions, as well as small business commissioners and representatives of small business. This consultation should focus on producing a document that is not only legally sound, but also understandable and useful to small businesses. The guide could also be disseminated through those channels once produced.

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#### RECOMMENDATION 15.7

Following the implementation of the Commission's proposed reforms to the insolvency system, the Australian Securities and Investments Commission (ASIC) should produce a Regulatory Guide targeted at small businesses facing financial difficulty.

The guide should cover legitimate restructure and liquidation options and responsibilities, with a focus on the new processes designed to assist small businesses.

ASIC should consult with the Australian Small Business Commissioner (or its successor), representatives of small business and the insolvency and legal professions in producing the guide.

### **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 12), 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. 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 where it has been used to carry on a business is an issue of emerging importance and that there may be merit in aligning the insolvency of trusts with the regime for companies, consistent with CAMAC's existing recommendation.

## **15.3 The Commission's proposed reform framework**

The complexity of companies and of the Corporations Act, as well as the sophistication of many parties (professional company directors, secured and unsecured corporate creditors,

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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.

Together with chapter 14, the above sections have considered the detail of specific, individual reforms. In addition to this, the Commission is mindful of how a ‘new’ insolvency system could fit together.

### **Improved governance provides access to improved processes**

The Commission has recommended a new defence for directors, and streamlining of liquidation for small companies. As a safeguard against abuse of these processes, they are only available where the parties come to them with the ‘clean hands’ of good governance practices.

The effect is twofold. First, a safeguard to prevent rogue or inept directors from accessing lower cost processes, and second as an incentive for those who don’t currently qualify for access to ‘clean up their act’ in order to do so.

### **Giving restructuring an opportunity to succeed**

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 will 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 through a formal process rather than attempting to ‘tough it out’ themselves.



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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) 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.

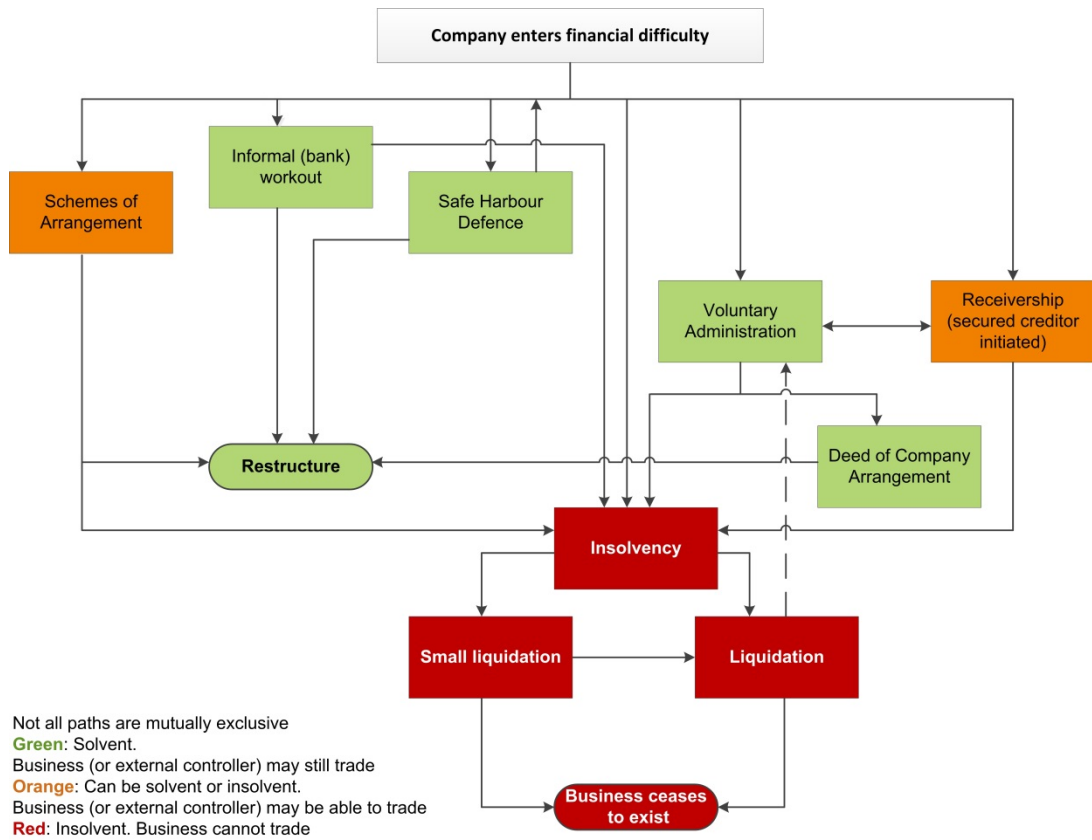
The Commission considers that a risk managed approach justifies a low level of investigation for a small company to be the *default* position. In awareness that expediting such liquidations could facilitate illegal phoenix activity, it has also recommended safeguards.

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 as discussed in this chapter and chapter 14. The Commission’s recommendations have not made direct changes to informal bank workouts, deeds of company arrangement, and the liquidation of large businesses. 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



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# A Inquiry conduct and participants

This appendix describes the stakeholder consultation process undertaken for the inquiry and lists the organisations and individuals that have participated.

Following receipt of the terms of reference for the 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 received 75 public submissions throughout the inquiry and these are listed in table A.1 and are available on the inquiry website.

In addition, the Commission had discussions with a number of businesses, business groups, academics and government agencies in Australia and overseas. 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.

Two days of public hearings were held for this inquiry. Hearing participants are listed in table A.4 and transcripts are available on the inquiry website.

The date for provision of the final report was extended by Government from 19 August 2015 to 30 September 2015, and a copy of the extension letter is included with the terms of reference at the front of this report.

The following public documents have been prepared by the Commission throughout the inquiry:

- Issues paper — released 19 December 2014
- Draft report — released 21 May 2015
- Final report — provided to Government on 30 September 2015 (to be released publicly within 25 parliamentary sitting days).

The Commission thanks all who have contributed to the inquiry.

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**Table A.1 Public submissions received**

<i>Participant</i>	<i>Submission number</i>
Ai Group	27
Arnold Bloch Leibler	23, DR65
Anderson, Helen; Ramsay, Ian and O'Connell, Ann — Melbourne Law School, and Welsh, Michelle — Department of Business Law and Taxation, Monash University	1, DR40, DR67
Australian Bankers' Association	DR63
Australian Bureau of Statistics	24
Australian Business Register	DR51
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, DR43
Australian Institute of Credit Management Pty Ltd	DR62
Australian Private Equity and Venture Capital Association Limited	DR72
Australian Property Institute	2
Australian Restructuring Insolvency & Turnaround Association	31, DR53
Australian Securities and Investments Commission	20, DR58
Australian Small Business Commissioner	10, DR57
Australian Trucking Association	13, DR48
BEC Australia	4
Buchan, Jenny	DR70
Business Law Section — Law Council of Australia	DR55
Business Council of Australia	29
Chamber of Commerce and Industry Queensland	8, DR44
Chartered Accountants Australia and New Zealand	DR52
Commercial and Property Law Research Centre — QLD University of Technology	DR64
CPA Australia	30
Crouch Amirbeaggi	DR68
Della-Polina, Ray	DR66
Department of Employment	12
DibbsBarker	DR46
Economic Security4Women	DR39
Family Business Australia	38
Foundation for Young Australians	DR56
Future Perspective	17, DR47
Google Australia	37
Governance Institute of Australia	DR41
GRG Momentum Pty Ltd	DR61
Griffith University and University of NSW	DR71
Hosted Accommodation Australia Ltd	22
Institute of Public Accountants	32, DR54
Institute of Public Affairs	5

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**Table A.1 (continued)**

<i>Participant</i>	<i>Submission no.</i>
Law Council of Australia	14, 36
Master Electricians Australia	6
McGrathNicol	34, DR60
Media, Entertainment & Arts Alliance	DR69
Motor Trade Association of SA	DR50
National Australia Bank (NAB)	7
Office of the NSW Small Business Commissioner	DR59
PricewaterhouseCoopers	DR75
PPB Advisory	DR42
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, DR45
Small Business Development Corporation	28
Tasmanian Government	18
The Accommodation Association of Australia	25
Tyro	15

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## Table A.2    **Consultations**

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Airtasker  
ACT Government  
ANU Connect Ventures  
Association of Superannuation Funds of Australia  
ATP Innovations  
Australian Bankers' 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 Financial Security Authority  
Australian Government Attorney-General's Department  
Australian Government Department of Agriculture  
Australian Government Department of Communications  
Australian Government Department of Industry and Science  
Australian Government Department of the Prime Minister and Cabinet  
Australian Government Department of the Prime Minister and Cabinet — Indigenous Affairs Group  
Australian Government Department of the Treasury  
Australian Institute of Credit Management  
Australian Minerals Exploration Council  
Australian Private Equity and Venture Capital Association Limited  
Australian Prudential Regulation Authority  
Australian Restructuring Insolvency and Turnaround Association  
Australian Securities and Investments Commission  
Australian Securities Exchange  
Australian Small Business Commissioner  
Australian Taxation Office  
Australian Transaction Reports and Analysis Centre  
BCR Advisory  
Blackbird Ventures  
Blackhall, Lachlan — Reposit Power  
Business Foundations  
Cameron, Michael — Rome2rio  
Canberra Innovation Network  
Chamber of Commerce and Industry of Western Australia  
Commonwealth Scientific and Industrial Research Organisation  
Council of Small Business Australia  
CPA Australia  
Customer Owned Banking Association  
Daly, Paul — Adelaide Entrepreneurship Forum  
Deloitte Centre for the Edge  
Drogovelic, Sasha — Hypa Works and BO\$\$ Camp  
Fishburners

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**Table A.2 (continued)**

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Family Business Australia  
Federal Court of Australia  
Foreign Investment Review Board  
Frazer, Lorelle — Griffith University  
Freelancer  
Griffin Accelerator  
HealthEngine  
Independent Contractors Australia  
Indigenous Business Australia  
Institute of Public Accountants  
Institute of Public Affairs  
IP Australia  
Kloud Solutions  
Law Society of Western Australia  
Arnold Bloch Leibler  
Lighthouse Business Innovation Centre  
Lindblom, Sarah — Threesixty, Business SA  
Mazzarol, Tim — University of Western Australia Business School  
Melbourne Accelerator Program  
Moorhouse, Anthony — Dynamiq  
MOTU Economic and Public Policy Institute  
Muru-D  
NAB Village  
NSW Small Business Commissioner  
O'Connor, Allan — Adelaide Entrepreneurship Commercialisation and Innovation Centre, University of Adelaide  
McGrath Nicol  
PricewaterhouseCoopers  
Reserve Bank of Australia  
Saldin, John — Venture Dorm  
Samuel, Graeme — Victorian Taxi Commissioner  
Schaper, Michael — Curtin University adjunct professor; and ACCC Deputy Chairman  
Small Business Development Corporation  
SME Association of Australia  
Smith, Dan — New Venture Institute, Flinders University  
South Australian Government Department of State Development  
StartupAUS  
Stokes, Jan — Business Innovation and Incubation Australia  
Supreme Court of New South Wales  
Supreme Court of Western Australia  
University of Canberra  
Victorian Department of Economic Development, Jobs, Transport and Resources  
Victorian Department of Premier and Cabinet  
Victorian Small Business Commissioner

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**Table A.2 (continued)**

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**Cambridge, United Kingdom**

Cambridge Enterprise Hauser Forum  
Centre for Business Research, Judge Business School, Cambridge  
St Johns Innovation Centre

**London, United Kingdom**

EditD  
Google Campus London  
IP Group  
KPMG UK  
Level39  
Mazzacato, Mariana — Professor at University of Sussex  
Nesta Investments  
Startup Manufactory  
UK Government Department for Business Innovation and Skills

**Boston, United States**

Artisan Asylum  
Lerner, Josh — Harvard Business School  
Martin Trust Centre for Entrepreneurship, MIT  
Masschallenge  
Stern, Scott — Professor at MIT Sloan School of Management, Technological Innovation, Entrepreneurship and Strategic Management Group

**Boulder, United States**

Morreale, Herb — entrepreneur  
Robertson, Neil — entrepreneur

**Chicago, United States**

Chicago Innovation Mentors  
MATTER  
Polsky Centre, Chicago Booth School of Business, University of Chicago  
1871 (Digital Start up Hub)

**New York, United States**

Center for Economic Transformation  
Empire State Development — Startup New York Program  
Empire State Development — Business attraction and expansion; Business Services  
KPMG Strategic Investments and Innovation  
Maiorano, Serafina — Advance  
Microsoft Civic Technology  
Partnership for New York City

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**Table A.2 (continued)**

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***San Francisco Bay area, United States***

Cooley, Godward, Kronish LLP — Jordon Silber  
Deloitte Centre for the Edge  
Engine  
Lee, Burton — Stanford University  
Melnik, Audrey — Zootrock / GrowthX  
Silicon Valley Bank  
Tesla Motors  
The Westly Group  
Williams, Hugh — Tinder

***Washington, United States***

Advanced Research Projects Agency — Energy (ARPA-E)  
Harner, Michelle — University of Maryland School of Law (United States of America)  
Information Technology and Innovation Foundation — Robert Atkinson  
US Small Business Administration Office of Advocacy, Office of Interagency Affairs — Charles Maresca  
US Small Business Administration Office of Investment and Innovation  
White, Clifford — US Trustee Program

***New Zealand***

Jaffe, Adam — Motu Economic and Public Policy Institute  
New Zealand Productivity Commission

***Israel***

Israeli Office of the Chief Scientist

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**Table A.3 Roundtable details and participants**

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**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 Investments 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

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## Table A.4 Public Hearings

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<i>Individual or organisation</i>	<i>Transcript page numbers</i>
<b>Melbourne — 22 June 2015</b>	
Anderson, Helen — Melbourne Law School, University of Melbourne	1-11
Arnold Bloch Leibler	12-25
Australian Restructuring Insolvency and Turnaround Association	25-49
Institute of Public Accountants	49-61
Future Perspective	62-65
<b>Sydney — 30 June 2015</b>	
Australian Bankers' Association	100-107
Australian Private Equity and Venture Capital Association	107-116
Buchan, Jenny — University of NSW Business School	116-123
Law Council of Australia	73-82
Shopping Centre Council of Australia	89-99

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