Don’t bet the house on it

When SME businesses are faced with a cash flow shortage, it is common for owners to draw against the equity in their family home as a quick fix or as a last resort to save their business from failure.

Unfortunately, this practice doesn't deal with the underlying problem and only serves to place the family residence in jeopardy. While the house may have been originally used as capital to kick start a business, it is often then deleveraged following years of hard work in making the business successful with profits being used to pay down the mortgage.

Our experience shows that owners are sometimes prepared to risk it all again by betting the business against the house. With Australian property vulnerable to falling prices given they are currently very high in world standards, this option may be limited in the future.

So if a business has a cash problem, what other immediate options are available to it rather than simply using the house as collateral for funding?

1. Seek to extend suppliers’ payment terms.
2. Enter into a payment arrangement with the ATO (if applicable).
3. Dispose of surplus assets.
4. Obtain funding against any unfinanced business assets (ie: debtors and equipment) or extend overdraft limit without the house being used as supporting security. (Financials will need to be up to date.)
5. Introduce an equity partner for a capital injection.
6. Sell the business.
7. Appoint a Voluntary Administrator and propose a Deed of Company Arrangement to compromise the debts with creditors.

If the company is not insolvent and the cash problem can be overcome in the short term, then the owner should also consider longer term strategies to avoid or at least be better prepared in future. This includes:

1. Understanding and learning from why the business ran out of cash.
2. Better use of the balance sheet by turning over inventory faster and collecting debts quicker.
3. Reducing expenditure where possible. This may include downsizing or moving premises to achieve cheaper rent.
4. Understanding the business better and recognising what drives the bottom line (ie: more sales may not necessarily mean more profit).
5. Diversifying customer base and concentrating on higher margin sales.
6. Improving techniques of cash flow management, forecasting and timely reporting.
7. Setting achievable goals and budgets and addressing material variances.

Unless a major debtor has gone bankrupt, a cash flow crisis doesn’t usually happen overnight. Owners of SME businesses should be on top of their cash flow management game and be aware of their statutory obligations under the Corporations Act to not trade whilst insolvent.

If a company incurs debts when it is insolvent, fails to comply with an ATO director penalty notice within 21 days or fails to pay certain unreported taxation liabilities within three months (subject to legislative approval following the 2011 Federal Budget), the director could be held personally liable and potentially lose the house.

If there is any question over solvency, it is crucial company directors seek professional advice at the earliest opportunity. With many SME business owners at baby boomer age and with insufficient superfund balances to meet the expected cost of living in retirement, they can’t afford to risk the house.

Ferrier Hodgson

If you are an SME, Ferrier Hodgson can:

- Advise on your company’s solvency and how to deal with it.
- Assess your company’s risk areas.
- Improve operational efficiencies.
- Consider restructuring options.
- Act as voluntary administrator.
If you are an SME financier, Ferrier Hodgson can:

- Provide pre-insolvency consulting advice.
- Consider restructuring options.
- Act as receiver and manager (if secured financier).

Please also refer to our online Voluntary Administration Guide for details on directors’ duties and options available to directors facing potential insolvency.

For further information on any of the above please contact us.

Regards