Poor cash flow cited as the leading cause of business insolvency

Australian Small Business and Family Enterprise Ombudsman (ASBFEO) Kate Carnell has called for payment legislation after an inquiry found that a lack of cash flow is the leading cause of insolvency in the business sector. Jirsch Sutherland Partner Stewart Free echoes the concerns and points out that many small business operators don't raise their hand until it's too late.

An inquiry into payment times and practices in Australia has revealed that poor cash flow is the primary reason for insolvency in Australia. Conducted by the Australian Small Business and Family Enterprise Ombudsman (ASBFEO) and involving more than 3000 submissions relating to transport, construction, mining and fast-moving consumer goods, the inquiry showed that late payments was the biggest source of anxiety for the small business sector.

Kate Carnell

Ombudsman Kate Carnell says late payments affect cash flow of the business owed the outstanding debt, forcing them to find ways to finance the shortfall in their working capital instead of being paid on time and using the cash flow to grow their business.

“A lack of cash flow is the leading cause of business insolvency and this underscores the importance of the issue of late payments which can eafsily put many businesses out of operation,” she explains.

The inquiry found that almost one in two businesses have more than $20,000 owing to them due to late payments.

“Of particular concern is the 14 per cent of businesses that have more than $100,000 owing to them,” says Kate. “This is a lot of money for businesses to have to do without. It is placing strain on cash flow and in some cases the very survival of the business.”

Furthermore, 35 per cent of respondents said they were at increased risk of insolvency or liquidation as a result of late payments, while 57 per cent of respondents needed to borrow or use credit cards due to late payments to their business.

Using small businesses as a cheap form of finance

Kate says extending payment times for small business suppliers effectively uses the businesses in the supply chain as a cheap form of finance.

“Small business should never have to act as a bank for big business, helping to finance multinational companies,” she says.

“This growing trend for extended payment times impacts the economy by slowing down the flow of cash through supply chains, which limits growth of businesses because they have more capital tied up in financing their operations and it raises the costs for businesses financing longer trade credit to their suppliers.”

When a business experiencing extended payment times is also hit with late payments, the added financial pressure can easily put them out of business.

“Poor cash flow is the primary reason for insolvency in Australia,” Kate says. “We’re in the process of developing a public register which highlights good and bad payment practices by Australian businesses.”

The flow on effect can mean small businesses are unable to pay their tax debts, which exacerbates a small business owner’s financial and personal stresses. ATO statistics show that small businesses make up the majority (65.2 per cent) of taxpayers with debts, and according to the ATO remain “a key area of focus” since just 72.3 per cent of small business tax liabilities got paid on time. A staggering $13 billion is reported to be owed to the ATO by small businesses with turnover up to $2 million.

Stewart Free

“Too often we see small businesses that raise their hand too late,” says Jirsch Sutherland Partner Stewart Free. “If a small business gets into financial stress, the owners could also risk losing their savings and their personal assets – and that’s obviously devastating.

Cash flow is the lifeblood of any business, and struggling with a day-to-day cash flow deficit puts a strain on an entire business and limits growth. With ‘credit clients’, it’s important to ensure there are well drafted trading terms in place, which allows for early and effective intervention when those terms aren’t adhered to.”

Industry codes to include payment times and practices

To help improve faster payment times and practices, the Ombudsman outlined a number of recommendations, one being industry-led codes which regulate business-to-business transactions.

Such codes, it stated, need to set a minimum best payment practice which should incorporate:

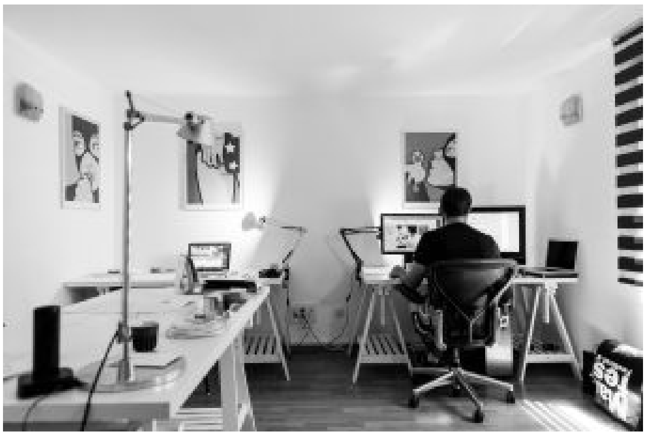
- A defined maximum payment time
- A mechanism to automatically apply late payment penalties either through interest measures or other forms of compensation
- Regular reporting to an independent external, possibly Government, body (such as ASBFEO, subject to funding)
- A compliance and enforcement mechanism

“Monitoring would need to be against both the benchmarks set by the industry and the minimum acceptable standards established by the monitoring body,” says the Ombudsman.

Developing a cooperative culture

“Large, medium and small businesses are deeply connected, meaning the long-term success of one depends on the success of the other, as does Australia’s overall prosperity,” she explains.

“Our research shows activity between large, medium and small businesses is already worth $520 billion a year, so when we work together more productively, it will not only benefit us, it will benefit the Australian economy as a whole.

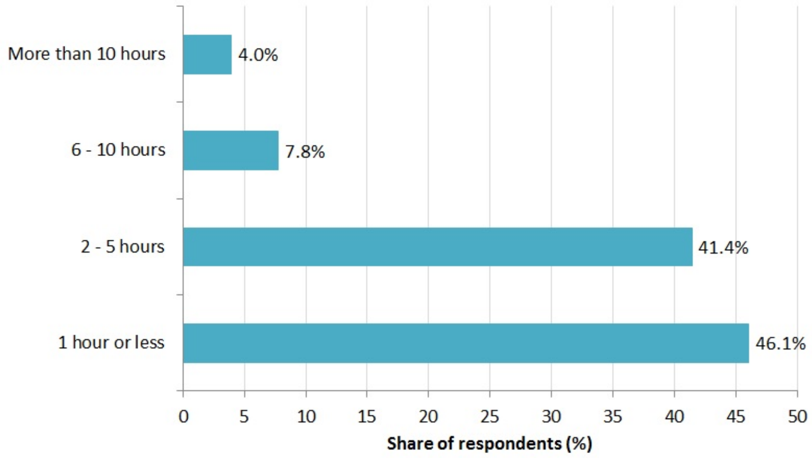


“A voluntary, industry-led effort to drive change in payments culture and practices should be given time to work before any consideration of regulation, which would impose extra costs on all business and taxpayers.”

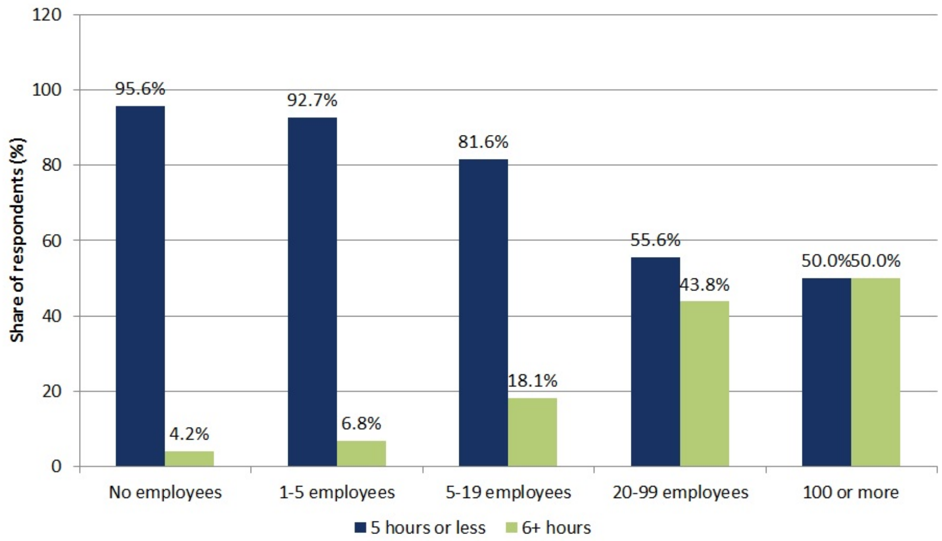
Business Council chief executive Jennifer Westacott believes the voluntary code for faster payment times and practices would foster a “culture of cooperation, not compliance” between small and large businesses.

Stewart Free points to Rio Tinto as a great example of a company taking into consideration small businesses. The company reduced the payment terms for Australian suppliers under $1 million of expenditure to 30 days to help improve the cash flow for thousands of small businesses. The change, which came into effect on July 1, will apply to more than 5,500 suppliers and about A$600 million in annual procurement spending by Rio Tinto in Australia.

Joanne Farrell, Rio Tinto's managing director Australia said: "Faster payment terms will help our smaller suppliers manage cash flow and help our local business partners to grow. A supply chain of strong local suppliers is good for our business, good for local communities and good for the economy."



Average time spent chasing late payments in a week. Courtesy of ASBFEO



Average time spent chasing late payments in a week. Courtesy of ASBFEO