SMALL BUSINESS INSIGHTS

SPECIAL REPORT

PART II

Crunch:
Cash flow challenges facing small businesses

SEPTEMBER 2022

These insights were produced by Xero and Accenture for Xero Small Business Insights

Contents

Executive summary

This report is the second of a two-part series investigating cash flow challenges facing small businesses in Australia, New Zealand and the United Kingdom. Part I set the scene by highlighting just how widespread and persistent the challenge of cash flow can be, as well as how this changed over the course of the COVID-19 pandemic.

This report, Part II, focuses on 'cash flow red flags' - the early warning indicators that a small business is heading for cash flow trouble. Both reports also include tips for accountants, bookkeepers and small businesses on how to improve cash flow management, and suggestions for governments on how they can play a role too.

For the purposes of this report, cash flow has been defined as revenue inflows (e.g. sale of goods and services for cash, or on credit, and other income) less expense outflows incurred within the month.[1] A month of negative cash flow, referred to as a cash flow crunch, is when expense outflows in a given month exceed revenue inflows.

The key findings from Part I were as follows:

- More than 9 in 10 businesses in Australia, New Zealand and the United Kingdom experience at least one month of negative cash flow each year. This occurs when monthly outgoings (such as rent and bills) are larger than monthly incomings (such as sales revenue).
- The average small business in Australia experienced 4.2 months of negative cash flow in 2021, while small businesses in New Zealand experienced 4.0 months and the United Kingdom 4.5 months.
- In Australia, one in five small businesses experienced more than six months of negative cash flow in the year, a potential indicator of ongoing cash flow stress. This compares to one in six small businesses in New Zealand and almost one in four in the United Kingdom.
- Cash flow conditions varied significantly by industry, both before and during the COVID-19 pandemic.
- Cash flow actually improved during 2020 and 2021 in part due to the high levels of government support provided to small businesses during the pandemic.

[1] This differs from the traditional accounting definition of cash flow, which is the net balance of all cash and cash equivalents moving into and out of a business.

In this second report, we analyse data from more than 200,000 small businesses to identify three 'red flags' that accountants, bookkeepers and small business owners should be looking out for when thinking about cash flow risks. These are: late payments, expense growth, and seasonality in operations. Understanding these challenges in more detail, including their impact on cash flow, is an important first step in identifying ways the small business economy can be supported to manage cash flow more effectively.

Cash flow red flags

1. **Late payments are linked to greater cash flow crunches.** Half of all payments made to small businesses are paid late, costing small businesses AU$1.1 billion per year in Australia, NZ$456 million in New Zealand and £684 million in the United Kingdom.[2] This report finds a relationship between being paid late and experiencing greater cash flow stress. In 2021, small businesses that received the majority (60%-80%) of their invoice payments late were more likely to experience a cash flow crunch; these businesses saw an average increase in cash flow crunches of 17% in Australia, 19% in New Zealand, and 6% in the United Kingdom, compared to businesses which were rarely paid late (<20%).
2. **Rising expenses increase cash flow stress.** Rising expenses began in earnest towards the latter stages of 2021, as pandemic-subdued inflation kicked up a notch around the world. As at June 2022, annual inflation growth was 6.1% in Australia, 7.3% in New Zealand and 8.2% in the United Kingdom.[3] Rapidly increasing inflation combined with labour shortages is driving record expenses growth for small businesses, with annual expenses in 2021 increasing by 14% year-on-year in Australia and New Zealand, and 18% year-on-year in the United Kingdom. If revenues do not grow at the same staggering rates, small businesses will face greater cash flow stress.
3. **Seasonal slowdowns** introduce cash flow uncertainty for many small businesses that rely on 'busy seasons'. Small businesses in hospitality tend to struggle with cash flow more in winter than they do in summer as a result of decreased activity during the colder season – 28% of UK-based hospitality small business sales come through in the summer months, but just 22% come through in the winter months. This volatility in revenue translates to greater cash flow stress. Looking more widely at the United Kingdom, 43% of small businesses are cash flow negative in the winter months, compared to 39% of the summer months.[4]

[2] Based on the time value of money for small businesses in each country. See the appendix for more detail.

[3] ABS, ONS, StatsNZ

[4] Data are pre-COVID-19 to exclude the effects of the COVID-19 pandemic.

1.0

Cash flow red flags

Managing cash flow effectively is not an easy or quick task. It requires understanding and juggling the inflows and outflows essential for business operations. This report details some of these challenges, including their impact on cash flow, as an important first step in identifying ways the small business economy can be supported to manage cash flow more effectively. It can also form the basis for targeted cash flow management advice and support.

1.1

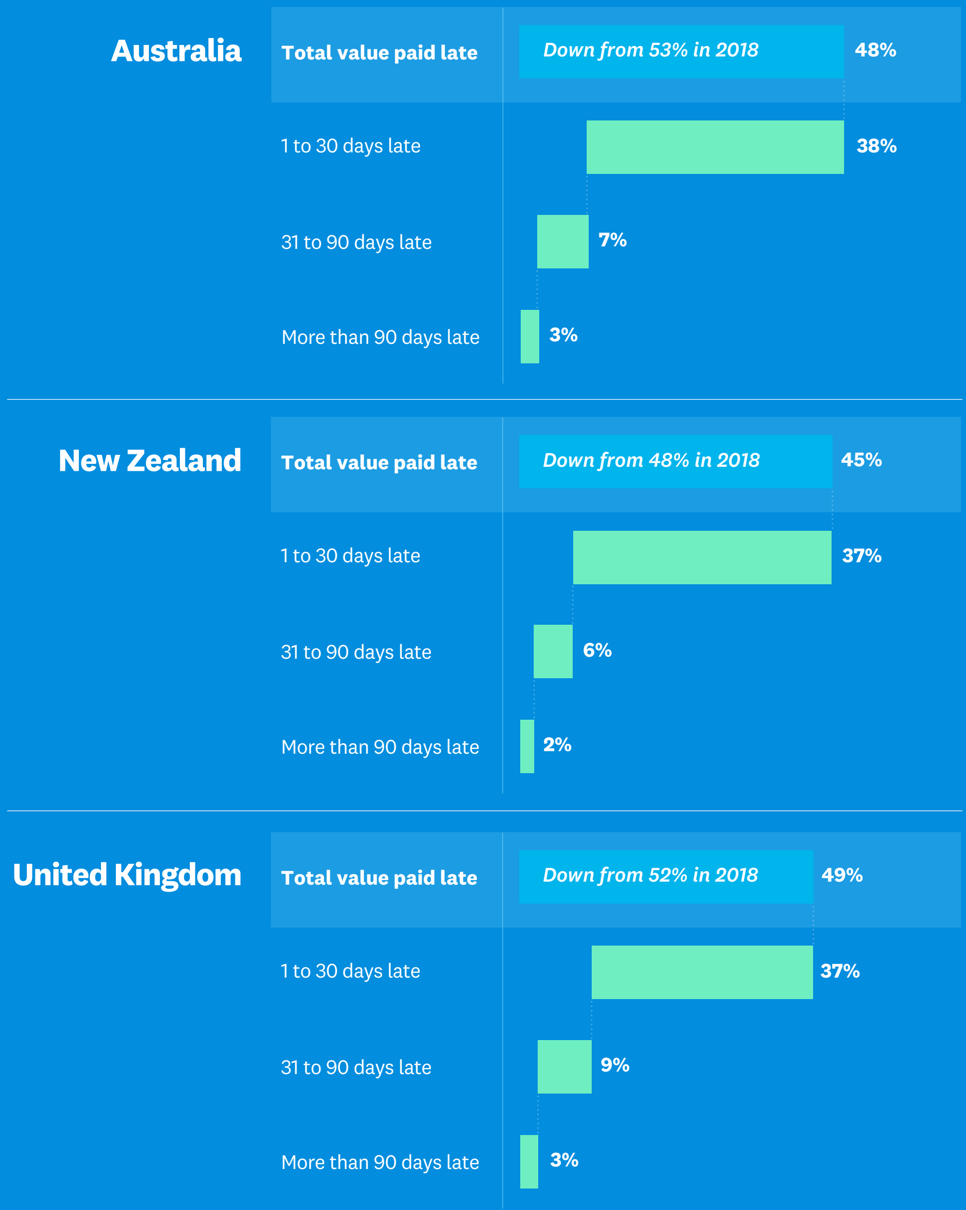
Late payments are linked to cash flow crunches

Almost half of all invoices issued by small businesses were paid late in 2021 (Figure 1), with around 10% being paid more than a month after they were due. When small businesses are paid late, it limits their ability to invest, grow and employ. Small businesses are responsible for the lion's share of a nation's economic output, so when small businesses struggle, the effect ripples through the whole economy.

Small businesses: Xero can help you get paid faster in a number of ways, including providing online payment options for your customers on your invoices, and setting up automatic reminders that are sent to your customers when their invoices are overdue.

Figure 1: Late payments by days late

Percentage of invoices paid late in 2021, value-weighted



Source: Xero Small Business Insights, Accenture

Figure 2: Average late payment time, and cost this imposes on small businesses

Average days late, seasonally adjusted as at February 2022;[5] Estimated cost of late payments to small businesses nationally considering the time value of money[6]

	Australia	New Zealand	United Kingdom
average days late	6.4	6.3	5.8
Cost to small businesses each year	AU $1.1bn	NZ $456m	£684m

Source: Xero Small Business Insights, Accenture

On average, small businesses are paid between 5.8 and 6.4 days late (Figure 2) with slight variations by country. Whilst this measure, from the Xero Small Business Index series,[7] improved after the initial shock of the pandemic, delays in receipt of payments have a real impact on a business' bottom line. It is estimated that late payments cost small businesses AU$1.1 billion per year in Australia, NZ$456 million in New Zealand and £684 million in the United Kingdom.[8] In this environment of late payments, balancing the books to avoid cash flow crunches each month is a persistent challenge.

Accountants and bookkeepers: Speak to your clients about the many ways you can help them implement technology-based solutions to help them get paid faster, such as online invoice payments and e-invoicing. The Xero App Store offers many apps that are designed to help small businesses get paid more quickly.

[5] Xero Small Business Index February 2022 release.

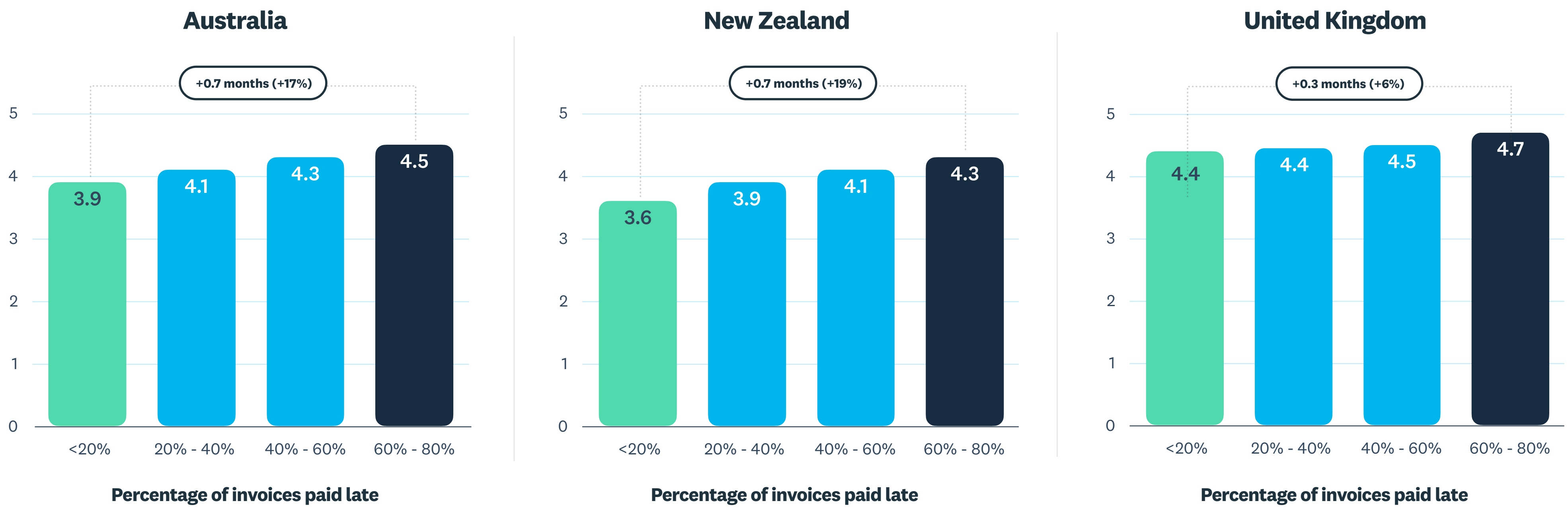
[6] Estimated using current business interest rates and sales volumes of small and medium sized businesses in each country. This calculation is based on businesses with less than 200 employees for Australia and less than 50 employees for New Zealand and the United Kingdom.

[7] This is the average number of days an invoice is paid after its due date, and includes instances when invoices are paid early.

[8] Based on the time value of money for small businesses in each country. See the appendix for more detail.

Figure 3: Being paid late contributes to greater cash flow stress

Average number of months of negative cash flow in 2021 (months), based on the percentage of invoices late (by value)



Source: Xero Small Business Insights, Accenture

Waiting longer for invoice payments unsurprisingly leads to a higher incidence of small business cash flow crunches. Small businesses that have a higher proportion of their invoices paid late experienced more cash flow crunches in 2021, as shown in Figure 3. This relationship was more pronounced for Australia and New Zealand, which both saw 0.7 month increases in average cash flow crunches between businesses that were regularly and rarely paid late. This effect was less pronounced in the United Kingdom, which saw just 0.3 months of difference.

Late payments are undoubtedly a cash flow red flag for many small businesses. If the burden of late payments was reduced to fewer than 20% of invoices, this change alone may ease the prevalence of negative cash flow months by up to 19% for some businesses.

1.2

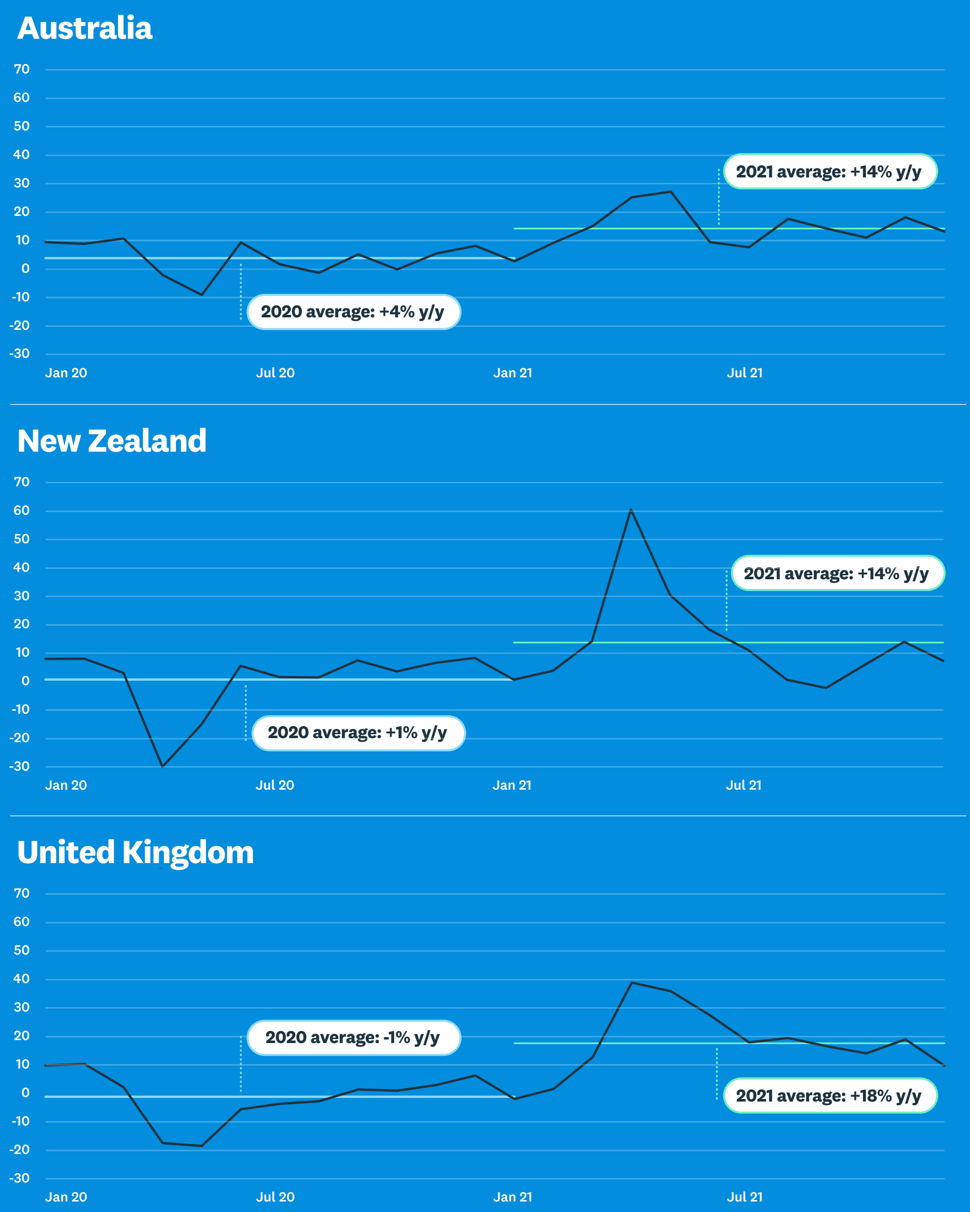
Rising expenses increase cash flow stress

Australia, New Zealand, and the United Kingdom are experiencing the highest rates of inflation in more than 30 years. Supply chain disruptions, coupled with heightened commodity prices such as oil, have contributed to rising costs for small businesses. Payroll costs are also increasing as labour markets tighten globally. As a consequence, it is likely that the majority of small business owners and their employees have never experienced an inflationary shock to the extent of the one currently unravelling around the world.

Insights in Figure 4 reveal that small businesses experienced significantly greater expenses growth in 2021 following the relative reprieve during 2020. Expenses were 14% higher in 2021 than in 2020 in Australia and New Zealand, and 18% higher in the United Kingdom. High growth in 2021 is partially due to below average growth during 2020, but these cost pressures still add up for small businesses. Pressure has continued on small businesses into 2022 with the continuation of this inflationary trend.

Fig 4: Expenses growth during the COVID-19 pandemic

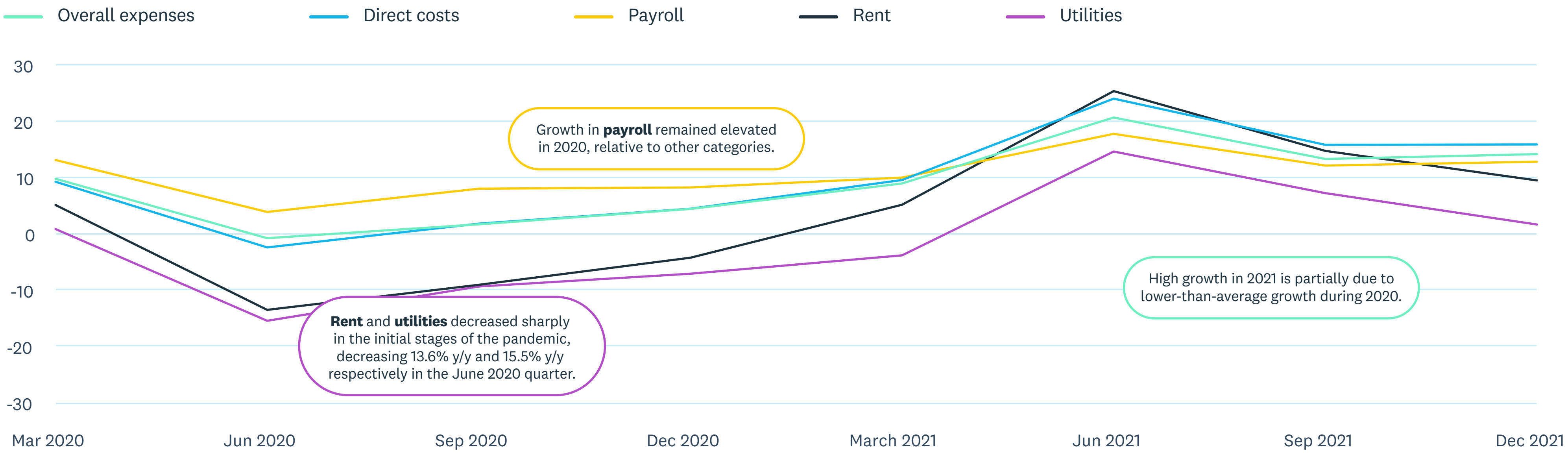
Percentage growth, year-on-year, 2020 and 2021, green lines denote annual average



Source: Xero Small Business Insights, Accenture

Figure 5: Growth in expenses, aggregate and by category, Australia

Percentage growth, year-on-year, quarterly average



Source: Xero Small Business Insights, Accenture

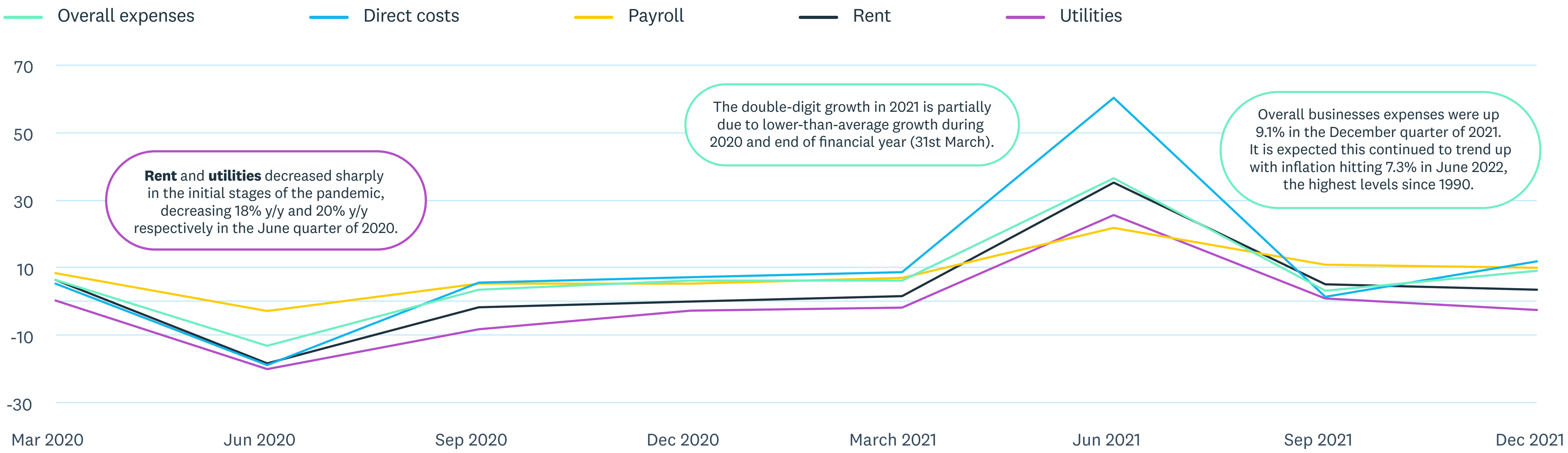
In mid-2020, yearly expenses growth dipped below 0% across all three countries, driven by rapid decreases in rent (e.g. rent relief) and utilities bills (e.g. millions of employees switched to working from home). However, not all areas of expenses were affected equally. Figure 5 presents a breakdown by category for Australian small businesses during the COVID-19-affected 2020-21 period:

- **Rent** decreased by 14% year-on-year in the June quarter of 2020, likely due to businesses seeking rent relief or opting for more flexible working spaces to reduce rental expenses. Rent rebounded towards the end of last year, growing by 9% year-on-year in the December quarter of 2021.
- **Utilities** (such as electricity and gas) decreased by 16% year-on-year in the June quarter of 2020, likely a direct effect of businesses being closed during lockdowns or staff working from home. These expenses remained subdued throughout 2021, growing just 2% year-on-year in the December quarter.
- **Payroll** costs remained elevated during 2020, indicating that valuable employer-employee relationships were maintained and businesses expanded their headcount in response to the rapid recovery following initial lockdowns. Payroll costs emerged as a fast-growing expense item in 2021, however, increasing almost 13% year-on-year in the December quarter of the year as states emerged from Delta lockdowns and labour shortages intensified around Australia.
- **Direct costs** (costs directly attributable to producing a good, or supplying a service) tracked the overall expenses growth relatively closely throughout the pandemic, rising to 24% year-on-year in the June quarter of 2021.

Small businesses: Now is the time to review your expenses and see where you can reduce your costs. Look for alternative suppliers that may be able to offer better prices; negotiate with your existing suppliers and ask for discounts for bulk purchases or early payments; review your subscriptions and cancel any that you no longer need; review all variable costs such as advertising and marketing to make sure you're getting an appropriate return on this investment.

Figure 6: Growth in expenses, aggregate and by category, New Zealand

Percentage growth, year-on-year, quarterly



Source: Xero Small Business Insights, Accenture

Figure 6 highlights a similar but more extreme trend in expenses growth in New Zealand:

- The more severe lockdown conditions in New Zealand (relative to Australia) led to more significant slowing of expenses growth in the June quarter of 2020 (-13% y/y) relative to Australia (-0.6% y/y). Similar to Australia, negative growth in rent and utilities were the key contributing factors (-18% and -20% y/y respectively).
- Growth in rent and utilities lagged overall expenses in the quarters following the June quarter 2020, likely due to work from home mandates and access to rent relief.
- In the June quarter 2021, expenses across all categories grew significantly, with overall expenses 36% higher than 12 months earlier. This growth is particularly due to the lower than usual growth in the previous year, as well as the impact of the end of financial year (31 March for New Zealand), which may have had a pronounced impact in 2021.
- Expenses continued to grow for the remaining quarters of 2021 (3.2% y/y in September quarter and 9.1% y/y in December quarter). This expense growth, which happened whilst many businesses were impacted by Delta lockdowns, was felt hard by small businesses.

This upward trend in expenses has continued into 2022 with the latest inflation figures in New Zealand, 7.3% year-on-year growth in the June quarter, which is the highest recorded since 1990.[9]

Accountants and bookkeepers: Work with your clients to mitigate the impact of rising costs to their businesses and the actions they can take to maintain profitability.

[9] StatsNZ

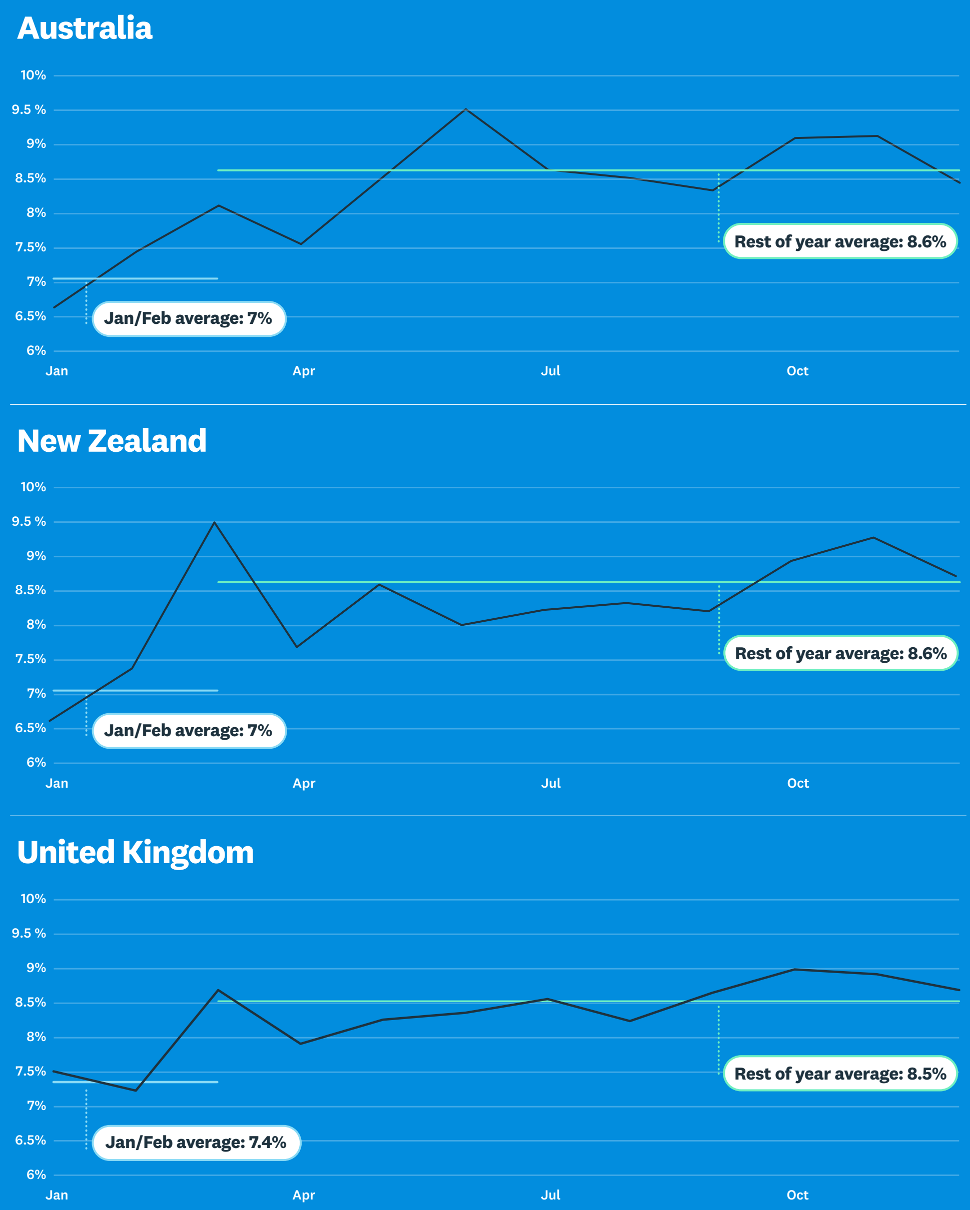
1.3

Seasonal slowdown bites

Our analysis supports anecdotal evidence that business activity is often slower in the first couple of months of the calendar year. Barring obvious exceptions which thrive off of summer trade in Australia and New Zealand, and winter trade in the United Kingdom, the average small business experiences a revenue speed bump in January and February, as shown in Figure 7. Small businesses in Australia and New Zealand receive 7% of their annual revenues in each of January and February, almost 20% less than the other 10 months of the year. The gap is smaller in the United Kingdom, where small businesses receive around 13% less than the other 10 months of the year.

Fig 7: Small business cash inflows are inherently seasonal

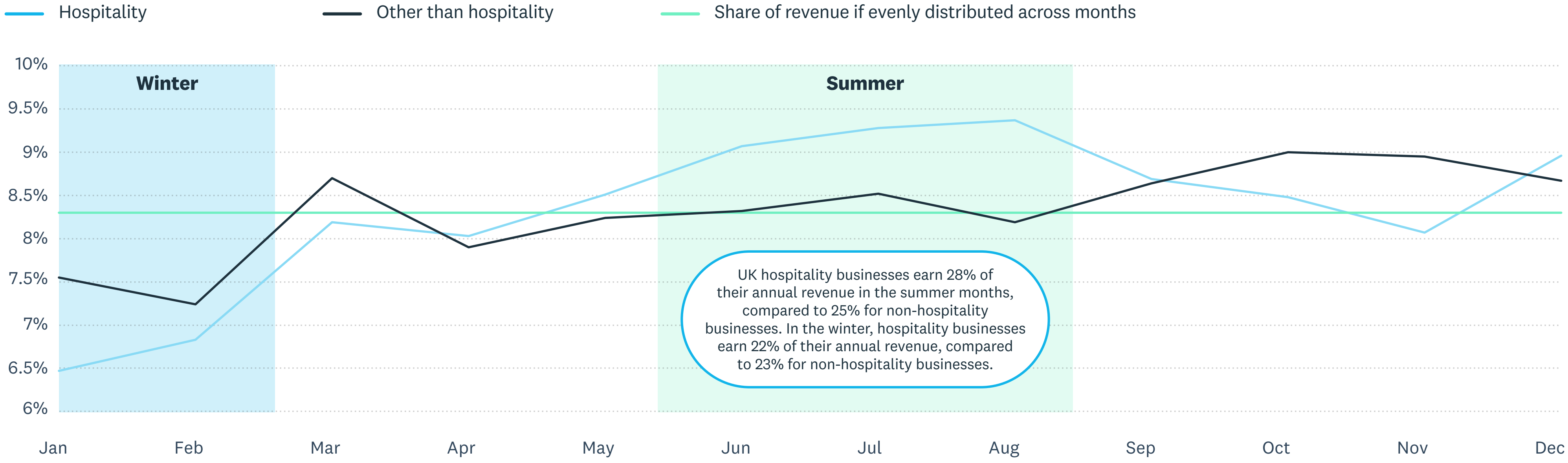
Average percentage of total annual revenue earned within the month, pre-COVID-19 (2017-19)



Source: Xero Small Business Insights, Accenture

Figure 8: UK hospitality small businesses are more seasonal than other businesses

Average percentage of total revenue earned within the month, pre-COVID-19 (2017-19)



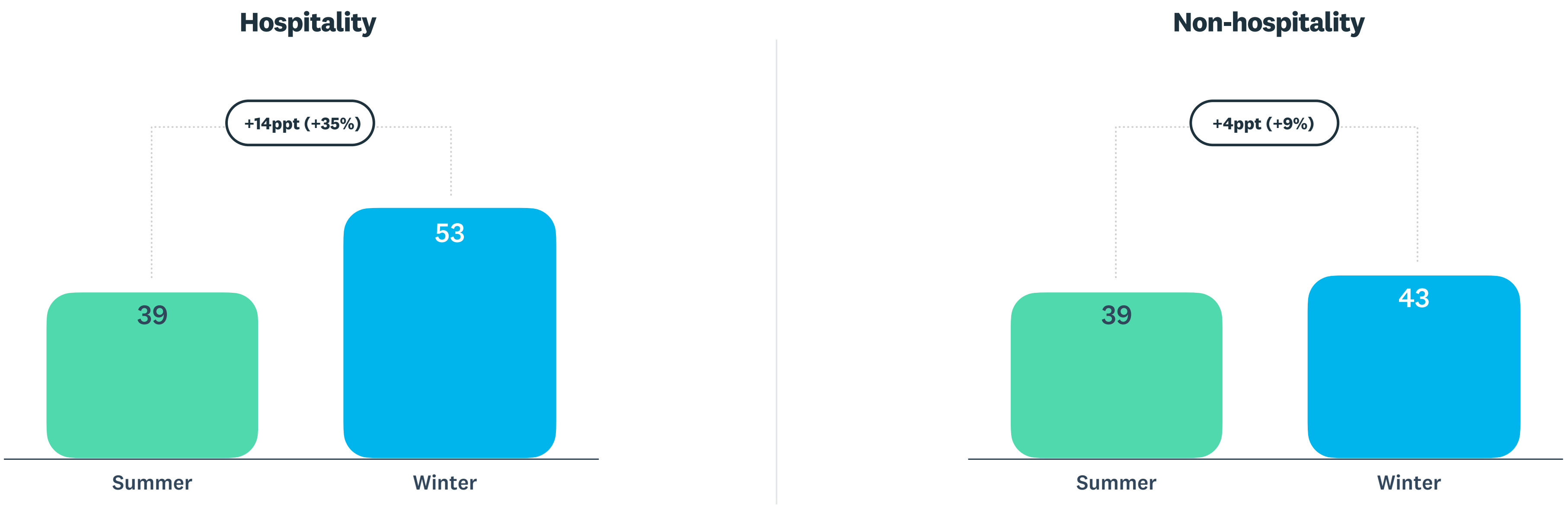
Source: Xero Small Business Insights, Accenture

Seasonal effects are even more pronounced for certain industries, such as hospitality in the United Kingdom. During the British winter, the average hospitality small businesses will generate noticeably less revenue compared to the summer months. Insights in Figure 8 show these businesses generate 28% of their annual revenues in summer, compared to 22% of their annual revenues in winter, even after accounting for elevated spend during the December holiday period.

Governments: Encourage tax collection agencies at all levels of government to work with small businesses on payment plan arrangements to help them navigate short-term cash flow challenges.

Figure 9: Seasonality results in more cash flow crunches for UK hospitality businesses in winter

Percentage of businesses experiencing negative cash flow in the average month within the season, pre-COVID-19 (2017-19) average



Source: Xero Small Business Insights, Accenture (Note: ‘ppt’ refers to percentage points)

Unsurprisingly, these revenue slowdowns translate to high rates of cash flow stress. Focusing again on the United Kingdom, Figure 9 shows that the rates of cash flow crunches are equal in the summer months (39%) between hospitality businesses and non-hospitality businesses. However, the winter months see elevated levels of negative cash flow for all small businesses, especially hospitality small businesses.

A massive 53% of the hospitality small businesses experience a cash flow crunch in a given winter month, compared to 43% for non-hospitality businesses. Clearly, there is a mismatch between revenues – which are responsive to climate – and expenses, which are less so. As hospitality small businesses see sustained drops in revenue across the coldest months, fixed costs remain the same and variable costs such as heating bills spike.

1.4

Conclusion

This two-part report series has highlighted cash flow management as a common and persistent challenge for small businesses across Australia, New Zealand and the United Kingdom. It has shown that more than 9 in 10 businesses experience at least one month of negative cash flow each year, and up to 1 in 4 businesses are cash flow negative more months than they are cash flow positive. The series has also shed light on the early warning signs of cash flow trouble: late payments, rising expenses and seasonal volatility in operations; plus provided tips for small businesses and their advisors to minimise cash flow crunches. The government can also play a role in cushioning cash flow crunches for small businesses, through programs such as Australia's newly introduced Payment Times Register[10] which reports on big businesses' payment times.

But at a time when businesses are still recovering from the challenges brought on by the pandemic, new risks are on the horizon. Inflation rates are on the rise, now at their highest levels since the early 1990s. Small businesses will need to be as savvy as ever to navigate this uncertain future and avoid the cash flow crunch.

Balanced Dog
New Zealand

[10] Payment Times Register

Methodology

Definition of small business

For the purpose of this report, a small business refers to any business present in the Xero data with annual sales less than the following thresholds in local currency: Australia: <$50m (consistent with definitions under the Corporations Act), New Zealand <$30m (Inland Revenue definition), United Kingdom <£6.5m (Companies House definition).

Estimation of cash flow

Cash flow insights were generated using Xero small business accounting data, which used revenue to represent cash inflows and expenses to represent cash outflows. A business' monthly cash flow position was determined by subtracting monthly expenses from monthly revenue – when this figure was negative a business is said to have experienced a cash flow crunch. Note that this definition differs from the traditional accounting definition of cash flow, which is the net balance of all cash and cash equivalents moving into and out of a business.

Several filters and exclusions were applied to ensure that the final sample was robust, consistent, and representative of the broader economy. In particular, small businesses were required to have reported a full 12 months of revenue and expenses each year to appear in the analysis, to ensure that comparisons across months and years are consistent. This requirement removed a large portion of the sample in the lowest turnover buckets, which includes businesses with turnover between AU$0 and $50,000 in Australia, NZ$0 and $100,000 in New Zealand, and £0 to £50,000 in the United Kingdom. The final sample of businesses used in this report (post-filtering) included more than 200,000 businesses from Australia, New Zealand and the United Kingdom.

Samples were reweighted by turnover ranges using official statistics data (ABS in Australia, StatsNZ in New Zealand, and ONS in the United Kingdom) to ensure that the results were representative of the broader small business economy. This weighting approach meant that the lower revenue bucket was excluded from the analysis so that these businesses weren't given outsized influence over the aggregate insights.

Late payments

We measure late payments in days, being the time between when an invoice is issued to a customer and when it is marked as fully paid in Xero. The late payment time measure is the average days an invoice is paid relative to its invoice due date and includes all paid invoices (regardless if they were paid early or late according to the payment terms). In calculating the late payment time we weight payment times by 1) invoice value, so that larger invoices matter more than smaller invoices, and 2) business-level sample weights, designed to match the population distribution of small businesses by industry. We exclude any invoice with a payment due date in excess of 12 months.

The cost of late payments to small businesses in each country has been estimated as the time value of the outstanding invoice value of all small and medium businesses in each country. This calculation is based on businesses with less than 200 employees for Australia and less than 50 employees for New Zealand and the United Kingdom. This is calculated by applying current interest rates (for small and medium sized businesses) to aggregate small and medium business sales in each country for the period equal to the average days late invoices paid (estimated using the approach above).

Revenue and expenses growth

We measure revenue and expenses from the general ledger, reported at the monthly level in the local currency of each country. Filters and adjustments are applied to as per the Xero Small Business Index sales metrics (see: www.xero.com/xerosbi) which includes removing missing data, extreme outliers and restricting to small or medium sized businesses to land on a robust sample for the analysis of both expenses and revenues. To remove reporting bias, only firms reporting both inflows and outflows 12 months of a given year were included. Growth is estimated by comparing revenue or expenses to the respective month one year prior to prevent changes in the sample composition impacting growth and implicitly correcting for any seasonal effects.

Methodology

Expense categorisation

We estimate expense categories by reviewing the categories within the chart of accounts and categorising expenses into Payroll, Rent and Utilities by matching keywords. Direct costs (excluding opening and closing inventory) are pulled directly from a user-categorised field. A high level summary is provided below:

Table A.1. ICT expenditure matching

Expense category	Key terms
Payroll	Wages, salaries, payroll, bonuses, annual leave expense, director's fees, holiday pay, superannuation, super, KiwiSaver, pension
Rent	Rent
Utilities	Electricity, gas, light, power

Authors and disclaimers

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Xero is a global small business platform with 3.3 million subscribers which includes a core accounting solution, payroll, workforce management, expenses and projects. Xero also provides access to financial services, and an ecosystem of more than 1,000 connected apps and more than 300 connections to banks and other financial institutions. Through Xero's open platform, small businesses can connect to a range of solutions that help them run their business and manage their finances. For three consecutive years (2020-2022) Xero was included in the Bloomberg Gender-Equality Index. In 2021, Xero was included in the Dow Jones Sustainability Index (DJSI), powered by the S&P Global Corporate Sustainability Assessment. Xero has been named as a FIFA Women's Football partner under FIFA's new commercial structure.

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The Xero Small Business Insights program provides unique, regular, and timely data showing how small businesses are performing and the important role they play in our community. These insights were produced by Xero and Accenture for Xero Small Business Insights. The principal source of small business insights in this report is customer data from Xero. Xero is a responsible custodian of its customers' sensitive data and does not release any data that could identify individual businesses. The data used is aggregated and anonymised to ensure the privacy of Xero subscribers, and their counterparts.

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