SMALL BUSINESS INSIGHTS

SPECIAL REPORT

PART I

Crunch: Cash flow challenges facing small businesses

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

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Executive summary

Sound cash flow management is essential to a thriving business. But, as any small business owner can attest to, it is much more easily said than done. This is especially true as businesses grapple with the aftermath of the pandemic and the rapid rise in inflation around the world.

This report is the first of a two-part series looking into cash flow challenges facing small businesses in Australia, New Zealand and the United Kingdom. Part I sets 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. Part II, to be released in the coming months, identifies 'cash flow red flags' - early warning indicators that a business might be headed 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.

In these reports, we draw on comprehensive data from more than 200,000 businesses across Australia, New Zealand and the United Kingdom.

The reports are focused on operating cash flow, which is the inflow and outflow of funds that is essential for daily business operations. Positive cash flow, when inflows exceed outflows, creates a cash buffer that provides the control and flexibility required for effective business operations. Negative cash flow hampers this control and flexibility, stifling the ability to thrive and grow. So much so, studies have shown that poor cash flow management is a common contributor to business failure.[1]

1. **More than 9 in 10 small businesses experience at least one month of negative cash flow each year.** Cash flow is a persistent and systemic challenge, with the average small business cash flow negative for 30% of the year. This equates to an average number of cash flow negative months of 4.2 in Australia, 4.0 in New Zealand and 4.5 months in the United Kingdom. Furthermore, one in four businesses in the United Kingdom is experiencing more intense cash flow stress, being cash flow negative more than six months each year. This figure is one in five in Australia and one in six in New Zealand. These staggeringly high figures underline cash flow as one of the most widespread challenges small businesses face today.
2. **The cash flow positions of most small businesses actually improved in 2020 and 2021.** This was primarily due to the government support provided to businesses during the COVID-19 pandemic. These findings show that although cash flow is an important measure of business health, it is not the only one. While many businesses remained cash flow positive through pandemic conditions, their overall operations and revenues were hindered by lockdowns, and thus they were far from thriving.
3. **There are differences across industries when it comes to managing cash flow.** This was most clearly evident during the pandemic when, on average, hospitality small businesses experienced more cash flow crunches than professional services businesses.

[1] Reserve Bank of Australia

1.0

The cash flow crunch

Maintaining healthy cash flow is an essential ingredient for a thriving business. In this report, we draw on comprehensive inflow and outflow data from more than 200,000 businesses across Australia, New Zealand and the United Kingdom to understand the extent of cash flow stress small businesses experience. We have defined cash flow 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.[2] A month of negative cash flow, referred to in this report as a cash flow crunch, is when expense outflows in a given month exceed revenue inflows.

Negative cash flow can create significant challenges for small businesses, particularly those with limited access to credit, and could manifest as staff reductions, expense cutting, inability to pay debts as they fall due, and owners deploying personal savings and equity to keep their company afloat. If cash flow crunches become a chronic and repeated occurrence, it can be the demise of small businesses.

Sian Kelly,
Inform Accounting
United Kingdom

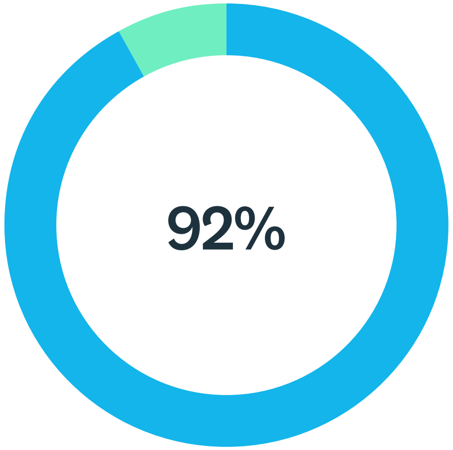
[2] This differs from the traditional accounting definition of cash flow, which is the net balance of all cash and cash equivalents moving into and out of a business.

More than 9 in 10 small businesses experience at least one month of negative cash flow each year

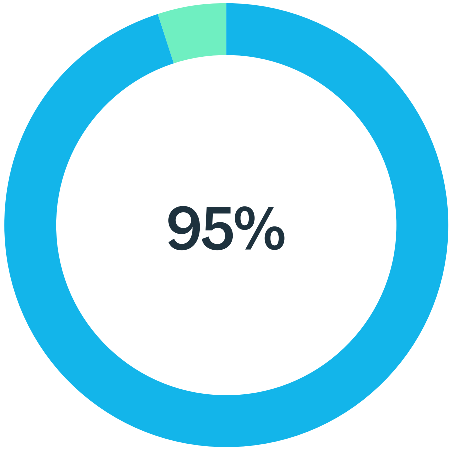
Figure 1: Small businesses experiencing negative cash flow at least once in 2021

Percentage of businesses that were cash flow negative at least once in 2021, weighted

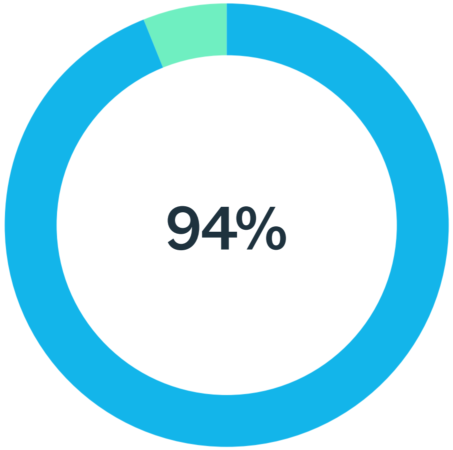
Australia



New Zealand



United Kingdom



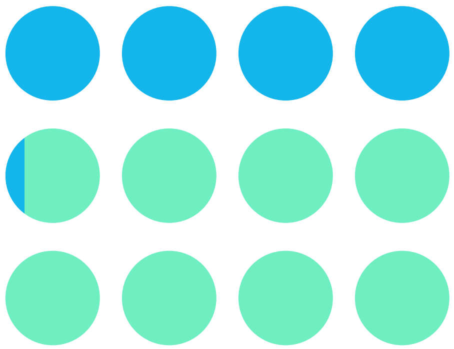
Source: Xero Small Business Insights, Accenture

More than 9 out of every 10 small businesses experienced at least one month of negative cash flow in 2021 (Figure 1). Cash flow is a persistent and systemic challenge, with the average small business cash flow negative for 30% of the year. As shown in Figure 2, this equates to an average number of cash flow negative months of 4.2 in Australia, 4.0 in New Zealand and 4.5 in the United Kingdom. These astoundingly high figures highlight that good cash flow management is much more easily said than done.

Figure 2: Average months of negative cash flow in 2021

Average months of negative cash flow per small business in 2021, weighted

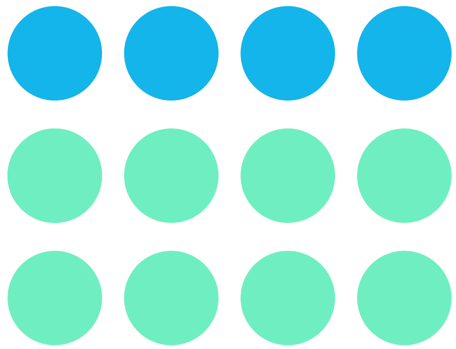
Australia



4.2

months of negative cash flow

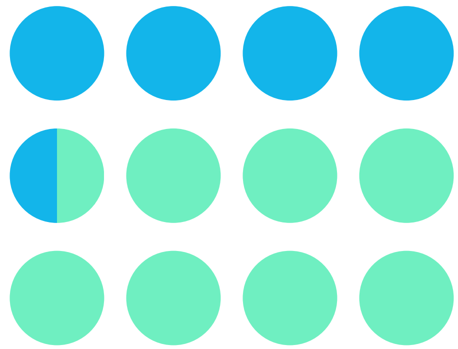
New Zealand



4.0

months of negative cash flow

United Kingdom



4.5

months of negative cash flow

Source: Xero Small Business Insights, Accenture

Accountants and bookkeepers: You could do a similar exercise with your clients – show them how many 'cash flow crunches' they have had in the past 12 months, and use this as a starting point to discuss how to make improvements for those with a higher-than-average number of crunches.

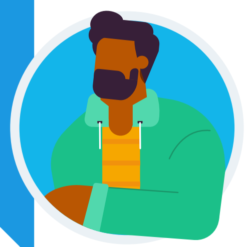
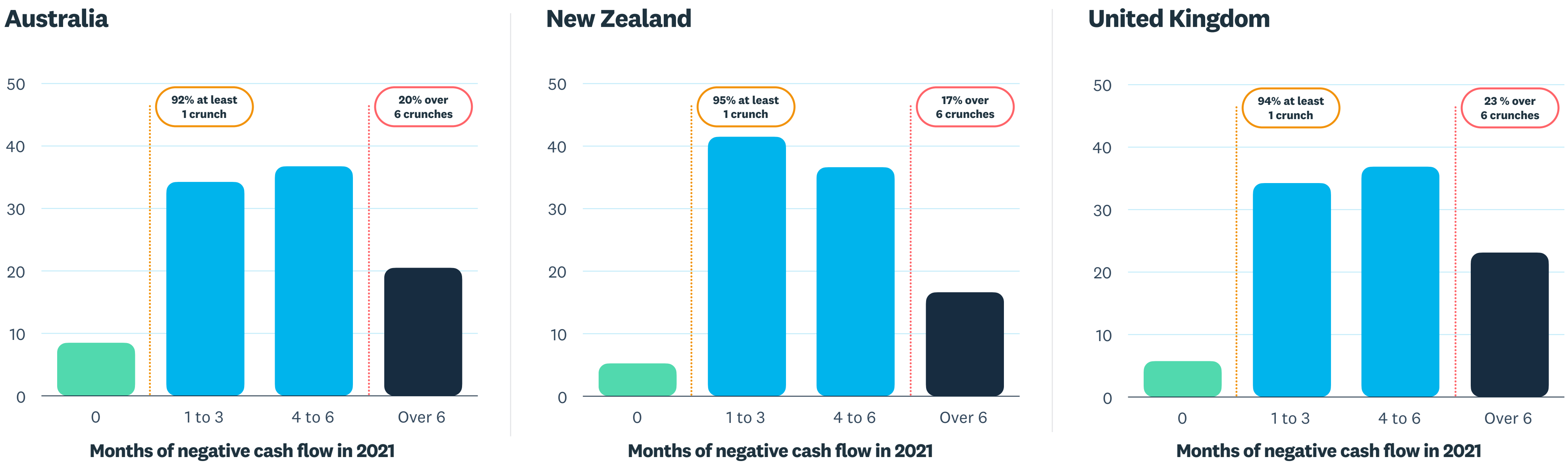


Figure 3: Rates of cash flow crunches 2021

Percentage of small businesses with X months of negative cash flow in 2021



Source: Xero Small Business Insights, Accenture

Most small businesses can get back on track after a brief period of negative cash flow. But for some, cash flow stress is more severe and ongoing. As shown in Figure 3, in Australia, one in five (20%) small businesses experienced more than six months of negative cash flow in the year, a potential indicator of chronic cash flow stress. This compared to one in six small businesses (17%) in New Zealand and almost one in four small businesses (23%) in the United Kingdom.

The high rates of cash flow crunches shown above, considered alongside the extent they can hamper businesses operations, underlines the need for businesses, with the support of their advisors, to understand the reasons for cash flow stress.

Small businesses: Having a budget is a great way to anticipate your cash flow crunches, and will empower you to plan ahead for the difficult months. The Budget Manager, within Xero, enables you to easily prepare budgets and compare them against your actual performance, helping you to keep on top of your cash inflows and outflows.

Governments: Utilise small business websites to provide handy tips and ideas for managing cash flow.

1.1

The cash flow positions of most small businesses improved throughout 2020 and 2021

One might imagine that rates of cash flow crunches are so high due to the economic downturn brought on by the COVID-19 pandemic. However, despite the immense challenges endured by small businesses throughout 2020 and 2021, the average cash flow position of small businesses actually improved.

- In Australia, the average small business experienced 4.2 months of negative cash flow in 2021, **0.2 months fewer** than in 2019 (4.4 months).
- In New Zealand, the average small business experienced 4.0 months of negative cash flow in 2021, **0.3 months fewer** than in 2019 (4.3 months).
- In the United Kingdom, the average small business experienced 4.5 months of negative cash flow in 2021, **0.2 months fewer** than in 2019 (4.7 months).

The unexpected but observed improvement in the cash flow position of small businesses during 2020 and 2021 is likely due to the interplay of three pandemic-specific factors:

1. Many businesses received a cash boost through government support and stimulus programs such as JobKeeper in Australia, the Wage Subsidy in New Zealand and the furlough scheme in the United Kingdom.

2. Some businesses could cushion the cash flow effect of lockdowns by cutting expenses, such as reducing variable costs like inventory or casual staff wages. By cutting these expenses, small businesses were able to minimise the cash flow impact of falling revenues typical during lockdown.[3]

3. Some businesses were able to sustain or even grow their revenues during the pandemic. A portion were able to change their business models (such as hospitality businesses moving to a take-away model) in order to continue trading and keep cash coming in. A select few managed to thrive on a sudden increase in demand sparked by the pandemic, such as was seen for home office furniture and gym equipment or protective masks.

The interplay of these effects can be seen in Figure 4.

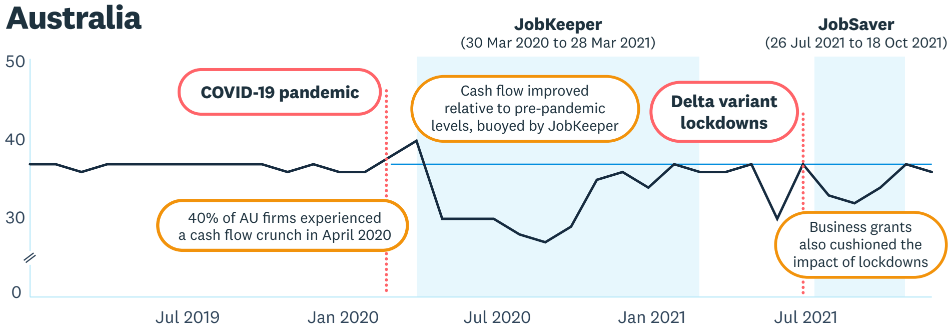
As the magnitude of the COVID-19 crisis became apparent in the early months of 2020, small businesses and governments acted quickly to secure their operations against the unprecedented shock to come in the months ahead. Figure 4 compares the percentage of small businesses that were cash flow negative pre-COVID-19 (2018-2019) to 2020 and 2021. The figures demonstrate that the cash flow positions of small businesses were significantly more volatile than prior to the pandemic.

[3] XSBI special report: Pandemic Insights: Small Business Experience, September 2020

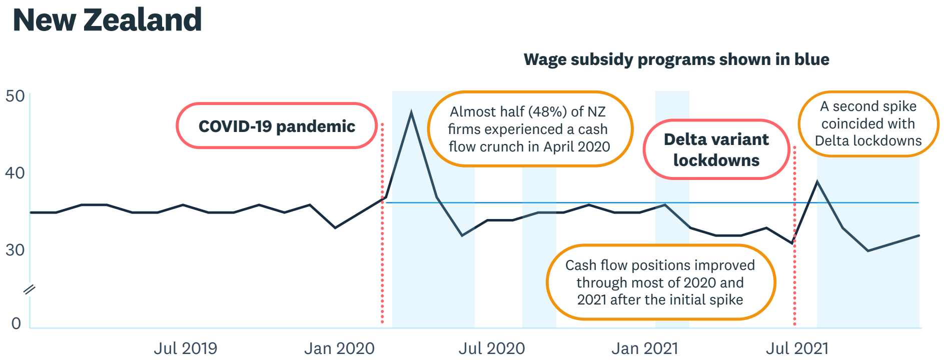
Figure 4: Cash flow crunches per month

Percentage of businesses with negative cash flow, weighted, monthly, seasonally adjusted

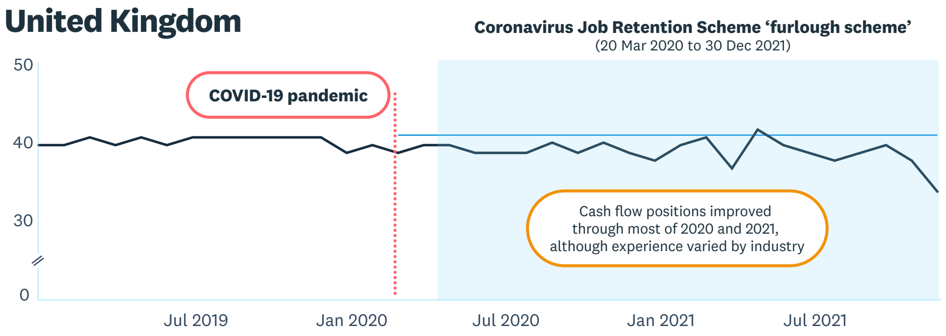
In Australia, an initial spike in the number of businesses experiencing negative cash flow in April 2020 coincided with the first wave of the pandemic and introduction of lockdowns. At this time, 40% (two in five) of businesses in Australia were cash flow negative, but this was followed by significant improvements in cash flow positions during the first tranche of JobKeeper, together with several other support programs including the Cash Flow Boost program.



In New Zealand, April 2020 saw a stark increase in cash flow crunches as almost half of all small businesses experienced negative cash flow within the month. The severity of lockdown conditions in New Zealand compared to Australia and the United Kingdom is a likely contributor to this experience. This was followed by a modest improvement over pre-COVID-19 rates, beginning in June 2020 as small businesses endured the brunt of the initial wave through support from the Wage Subsidy program.



The United Kingdom did not see an increase in the share of firms experiencing a cash flow crunch in April 2020 unlike Australia and New Zealand, likely due to the Coronavirus Job Retention Scheme (commonly referred to as the furlough scheme) being announced mid-March and backdated to the beginning of March. Lockdown conditions in the United Kingdom were usually less severe than those in Australia and New Zealand.



These findings show that although cash flow is an important measure of business health, it is not the only one. While many businesses remained cash flow positive through pandemic conditions, their overall operations and revenues were hindered by lockdowns, and thus far from thriving.

Source: Xero Small Business Insights, Accenture

1.2

Industry variation in cash flow

Rates of cash flow crunches varied significantly by key industries, both before and during the COVID-19 pandemic (Figure 5). In 2019, UK small businesses in the professional services industry were less likely to be cash flow negative in a given month (38%) compared to those in the retail and hospitality industries (45% and 44% respectively). Throughout 2020 and 2021, the cash flow health of these businesses was impacted to varying degrees:

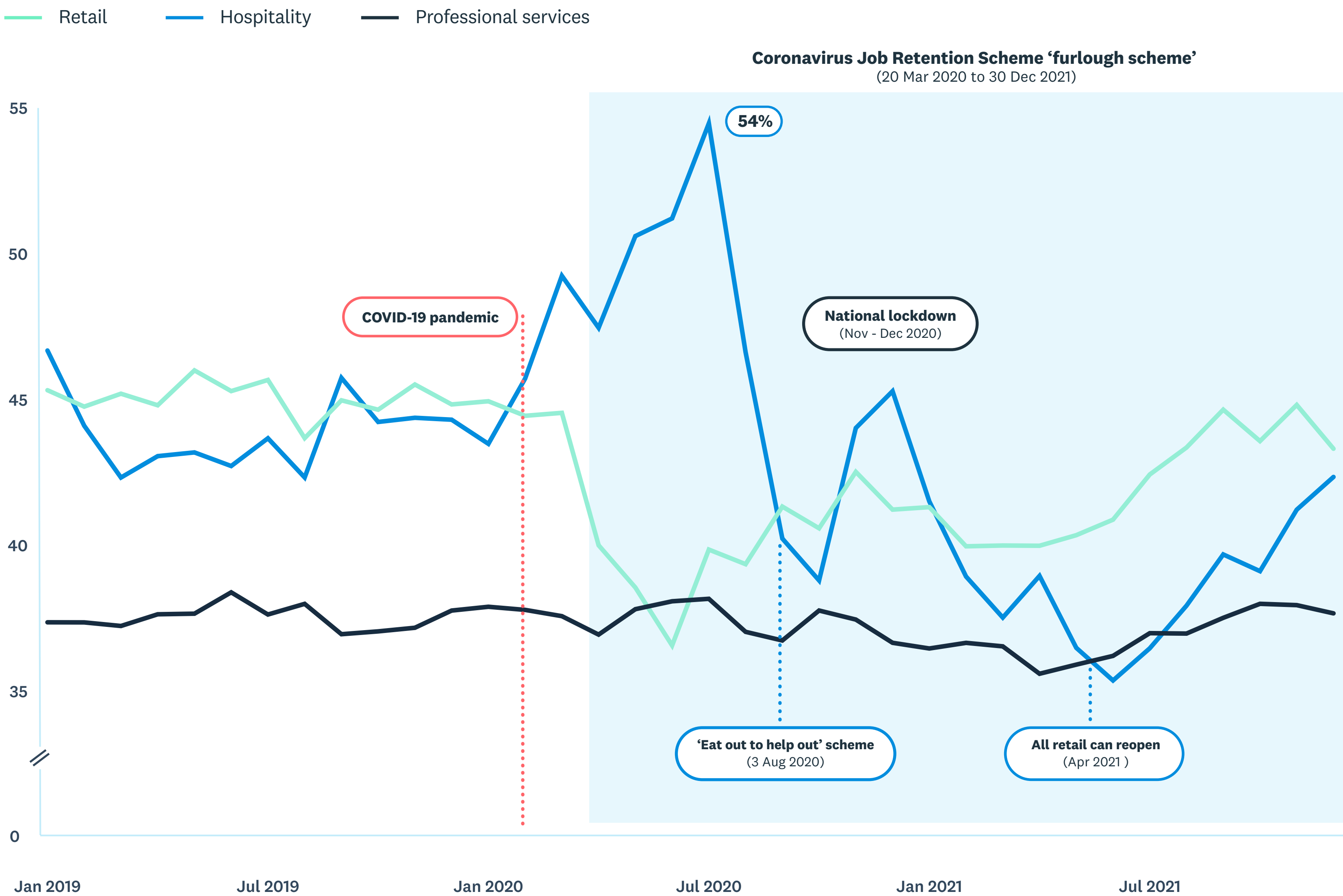
- Hospitality small businesses felt the brunt of the initial COVID-19 impacts, with rates of cash flow crunches rising rapidly with the onset of the pandemic, peaking at 54% in July 2020. Cash flow health progressively improved in the subsequent months as businesses accessed government support such as the Coronavirus Job Retention Scheme (CJRS), cut their expenses, and activity was bolstered by the 'eat out to help out' scheme. As a result, the proportion of businesses being cash flow negative fell to 38% in August 2020, below pre-pandemic rates. With the exception of November and December 2020, when a national lockdown was reintroduced, the percentage of hospitality businesses experiencing negative cash flow remained below pre-pandemic rates.
- Unlike hospitality, retail small businesses did not see the initial uptick in the rates of cash flow crunches during the onset of the pandemic in early 2020. In fact, in June 2020 only 37% of businesses were cash flow negative, fewer than before the pandemic (45%). This can be partly explained by the relative immunity of online retailers to lockdown conditions, plus the support flowing from the furlough scheme in this time.
- Professional services businesses fared relatively well both pre-COVID-19 and during the pandemic. They consistently saw the lowest number of businesses experiencing negative cash flow in 2019 (38% of businesses experiencing negative cash flow in a given month), and this remained relatively unchanged throughout 2020 and 2021.

Small businesses: Many government agencies are willing to help small businesses suffering from temporary cash flow crunches. The earlier you speak to these agencies, such as tax offices, the sooner they can put in place a payment plan to help you through. Don't ignore the problem and delay getting help.

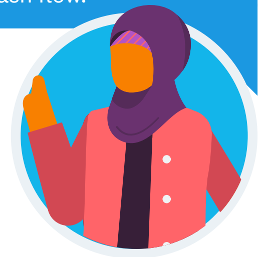
Governments: Governments could help reduce the number of cash flow crunches small businesses experience by ensuring that public procurement contracts with small businesses include a late payments clause that commits to paying penalties for late payment.

Figure 5: Proportion of businesses which were cash flow negative, selected industries, United Kingdom

Percentage of UK small businesses with negative cash flow, monthly, seasonally adjusted[4]



Accountants and bookkeepers: Educate your clients on Xero's inbuilt short-term, cash flow projection function to help them manage their short term cash flow.



[4] Results are presented as three-month rolling averages due to increased volatility in the industry series.

1.3

Next steps

Part II of this research, to be released in the coming months, will highlight the red flags that small businesses and their advisors should look out for when it comes to cash flow risk.

Jem Selig Freeman, Like Butter
Australia

2.1 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 small business's 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 A$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 (Australian Bureau of Statistics in Australia, Stats New Zealand in New Zealand, and Office for National Statistics 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.

2.2 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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About Xero Small Business Insights

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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