Australian Government

Australian Small Business and Family Enterprise Ombudsman

Payment Times and Practices Inquiry - Final Report

April 2017

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Contents

"Payment times matter" or "How I started using small businesses to finance my multinational conglomerate"

Two issues affecting businesses of all sizes are:

- **Late payment times:** getting paid beyond the agreed time in the contract; and
- **Extended payment terms**: payment times beyond usual industry standards.

Both of these issues are related to trade credit terms agreed between businesses when conducting business. Trade credit is the practice of supplying goods and services to businesses or individuals with payment at an agreed later date.

Late payments have been a perennial problem for businesses in Australia. Recent research shows Australia lagging internationally, as shown in Figure 1 Average Payday 2015. Late payments affect cash flow of the business owed the outstanding debt, forcing them to find ways to finance the short fall 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 easily put many businesses out of operation.

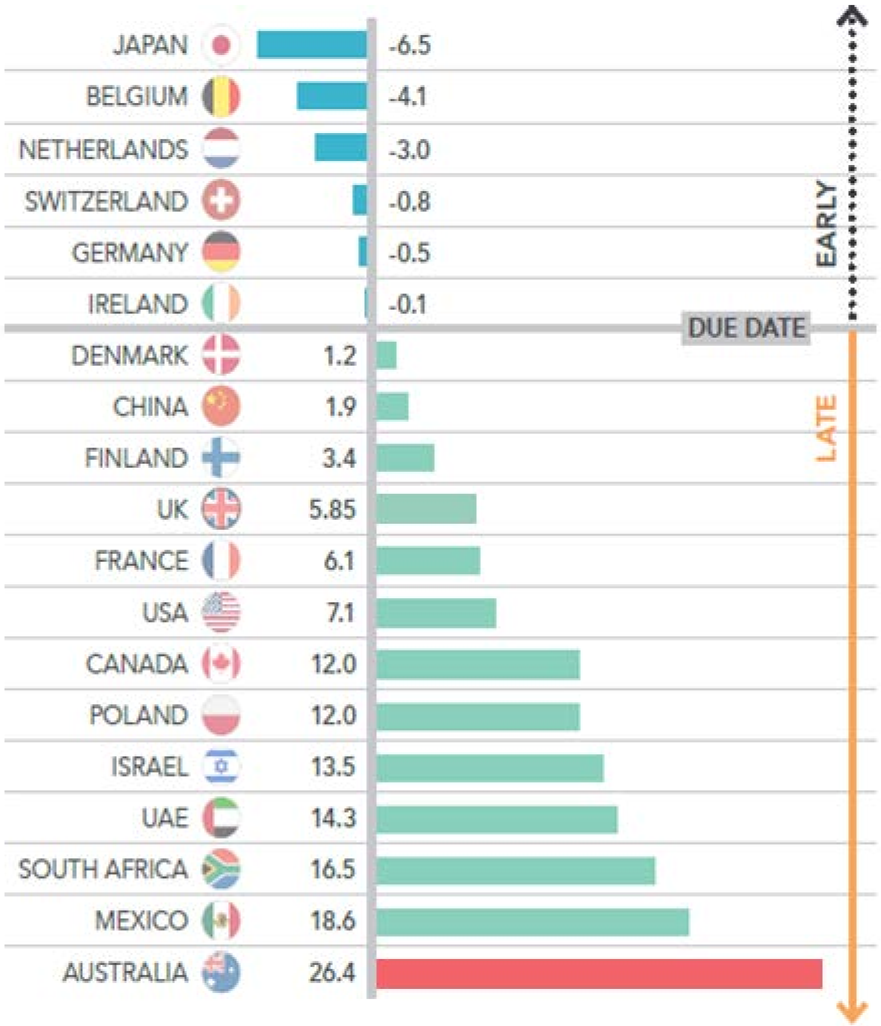

Figure 1 Average Payday 2015
Source: The State of Late Payment 2016 www.marketinvoice.com

Against the backdrop of late payments, there has been a growing trend in payment practices, particularly amongst large Australian and multinational businesses, to extend payment times. The growth in extended payment times is partly linked to the practices of multinational businesses who apply global policies to improve their working capital efficiency. Extending payment times for suppliers effectively uses the businesses in the supply chain as a cheap form of finance.

The growing trend for extended payment times impacts the economy in two ways. Firstly, it slows down the flow of cash through supply chains which limits the growth of businesses as they have more capital tied up in financing their operations and secondly it raises costs for businesses which are financing longer trade credit to their customers.

When a business experiencing extended payment times also experiences late payments it will stress the business further with significant ramifications for the solvency of the business. Aside from these business challenges, there are a range of personal effects which spill-over including mental health issues.

Something must be done.

The government has a role as first mover to reverse the trend. Learnings from overseas jurisdictions show the power of government action through faster payment times to suppliers and using government procurement policies to spread the economic benefits of faster payment through the whole supply chain by requiring government terms to be replicated in sub-contracts.

Transparency is critical to allow suppliers and customers to make informed decisions and a boundary on what is an acceptable maximum term is needed. While voluntary codes and other soft measures provide an option for businesses to signal their good intentions it is only the power of legislation which will compel businesses to meet payment standards and address late and extended payment times. Industry-specific codes with articulated payment times as well as greater adoption of technology by businesses can also assist in addressing both late and extended payment times.

The recommendations and action items raised in this report will address these issues going forward.

How can payment times and practices be improved?

Recommendation 1: The Australian Government to adopt a 15 business day payment time by July 2018. All levels of government to consider adopting.

Recommendation 2: The Australian Government to require its head contractors to adopt the payment times and practices of the procurement through its supply chain. All levels of government to consider adopting.

Recommendation 3: The Australian Government to extend its payment policies to all its agencies and entities. All levels of government to consider adopting.

Recommendation 4: The Australian Government to publish its payment times and policies, and for all its agencies and entities, with performance against best practice benchmarks. All levels of government to consider adopting.

Recommendation 5: The Australian Government to mandate the use of Project Bank Accounts in public works and construction projects. All levels of government to consider adopting.

Recommendation 6: The Australian Government to procure from businesses which have supply chain payment times and practices equal to or better than its practices. All levels of government to consider adopting.

Recommendation 7: Industry codes which regulate business to business transactions to include best payment practices including set payment times.

Recommendation 8: The Australian Government to introduce legislation for larger businesses to publicly disclose all of their payment times and practices and performance against those terms. Larger businesses being the top 100 listed on the ASX and multinationals.

Recommendation 9: Australian Government to introduce legislation which sets a maximum payment time for business to business transactions. Certain industries may need terms greater than the maximum which can be agreed providing they are not grossly unfair to one party. Where a longer term is called into dispute it will be considered an unfair contract term.

Recommendation 10: Governments should encourage the adoption of technology solutions, such as e-invoicing, to assist business to streamline administrative tasks and facilitate payment practices.

ASBFEO action items

- Develop a National Payment Transparency Register to publish businesses payment times and practices rated against a benchmark for good and bad performers.
- Work with ASIC and other agencies on extending measures to increase the awareness of the need for businesses to manage working capital through targeted programs.
- Research access to justice issues for businesses to develop a process for quick (within 14 days of lodging) determination of liability in relation to non-payment of supply.
- Contribute information from the Inquiry concerning payment issues in the building and construction industry to the Murray Review into security of payments legislation.
- Work with the government agencies monitoring trade credit in the economy with a view to examining the role of trade credit on growth in the Australian economy.
- Engage with the appropriate government agencies to examine avenues to improve government procurement and payment practices.
- Examine the feasibility of establishing a National Small Business Register to allow businesses to self-identify themselves for government and commercial activities.
- Work with the Australian Competition and Consumer Commission to review payment times and practices by industry against the unfair contract terms legislation.

Background

The Office of the Australian Small Business and Family Enterprise Ombudsman (ASBFEO) conducted its first self-initiated inquiry from November 2016 to April 2017 on Payment Times and Practices in Australia. The Inquiry came as a result of feedback from small business and family enterprise during 2016 saying that late and extended payments is their number one problem. The Inquiry was conducted in consultation with a reference group of state-based Small Business Commissioners, the Council of Small Business Australia (COSBOA), The Australian Institute of Credit Management (AICM) and the Institute of Public Accountants (IPA).

The terms of reference were to consider:

- the practice of corporations setting payment terms particularly for small businesses;
- trends in payment terms and late payment with emphasis on commercial dealings between small business with large corporations;
- the effects and impacts that long payment times have on small businesses; and
- potential regulatory and market-based responses available including recent developments such as unfair contracts legislation.

This report is part of a suite of papers which document the research accumulated during the Inquiry. There are three working papers which support this report and these are to be read in conjunction with this report. These working papers are:

1. Trade Credit, Australian Government policies and overseas responses to payments practices.
2. Submissions, consultations and large business practices.
3. Analysis of survey responses.

The Inquiry commenced on 16 November 2016 and collected data through a variety of mechanisms including:

- a public submission process from 16 November 2016 to 13 January 2017;
- an on-line survey from 12 December 2016 to 28 February 2017;
- a letter campaign to over 100 larger Australian and multinational businesses; and
- consultations with government departments, regulators, industry regulators, foreign governments, larger businesses and academics.

The activities and powers of the Ombudsman are governed by the *Australian Small Business and Family Enterprise Act 2015* (the Act) and the *Australian Small Business and Family Enterprise (Consequential and Transitional Provisions) Act 2015*. Under division 2 section 36 of the Act, the Ombudsman may, on the Ombudsman's own initiative, conduct research and inquiries into the effect of legislation, policies and practices on small business or family enterprise and the ways in which relevant legislation, policies and practices may be improved to assist small business or family enterprise. In undertaking such an inquiry the Ombudsman may:

- inform himself or herself on any matter in any way the Ombudsman thinks fit;
- consult with anyone the Ombudsman thinks fit; and
- receive written or oral information or submissions.

Maximising governments role as payment leaders

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Rationale:

- Governments across Australia collectively spend over $100 billion annually.
- There are economic benefits to paying suppliers faster and having these benefits flow through supply chains.
- Reliable and fast cash flow allows business to invest, grow and employ to meet government's objectives in economic and employment growth.
- Government should set the example with fast payment times to suppliers.

Inquiry research

Overseas jurisdictions have demonstrated that faster payments through supply chains will free up cash flow and stimulate investment, jobs and growth. Australian governments have a large procurement spend and collectively all levels of government (Australian, state and territory and local) spend over $100 billion annually. As larger businesses, governments can, and do, dictate the times on which they purchase goods and services. Presently, the majority of standard government policies have payment times around 30 days net and policies or contract terms which allow penalty interest. Strengthening government procurement and payment time policies will have a positive impact with economic benefits.

A large number of overseas jurisdictions have payment times and policies which seek to maximise the benefit of government procurement by paying suppliers faster. Some of these policies require the times and practices to flow through the supply chain. This includes the United Kingdom (UK) and the United States (US). A recent study of the impact of the US policy demonstrated that faster payment to businesses in the supply chain yielded increases in employment and wage growth – estimated at around 75,000 jobs and $6 billion in annual wage growth. An UK audit office report into its policy highlighted the cost savings to business are larger than the one-off cost to government to implement faster payment times.

Presently the benefits of most government prompt payments are limited to those suppliers which are directly contracted. There are a large number of government entities which are not subject to prompt payment policies such as hospitals and government business entities. The scope of policies should be expanded to cover all government entities including government business enterprises for maximum effect.

Survey evidence indicates that despite the existence of government prompt payment policies some agencies continue to pay late. Over 20% of survey respondents noted that some Australian, state and territory government departments always or frequently paid late. This contrasts with the recent government report which shows on average 97% of a selection of 32 Australian Government agencies are paying on time with similar reports from state and territory governments.

In addition, the designs of some policies mean that penalties such as late payment interest are not effective. The threshold for paying penalty interest may be set too high which effectively gives late paying agencies a free pass. For example, in FY16 the Australian Government only paid $250,792 in late payment penalty interest on over $206 million in late payments. This is less than 0.12%. This is not a significant penalty to the agencies concerned and indicates the threshold to trigger payment is too low to act as a incentive to pay on time (presently interest is only payable once the late payment interest reaches over $100).

Similarly other government policies require the supplier to separately claim the interest penalty. Consequently suppliers are not seeking to claim the entitled penalty for fear of antagonising the relationship. Where late payment interest is due it should be automatically applied by the agency. This has been raised in the last two years with media reports into the penalty interest policies of two state governments being scrutinised for requiring suppliers to claim.

Prompt payment policies should be published with regular self-reporting of performance against these times. Ambitious benchmarks should be set and used to assess the performance of governments.

Policies should also mandate the use of Project Bank Accounts (PBAs). PBAs, depending on the design adopted, require the establishment of a trust account for payments and retention monies. This ring fences the monies for future payment (in case of insolvency of the prime contractor) and assists in reducing payment times for subcontractors. The benefits of project bank accounts have been demonstrated by state government and overseas experiences. Modelling for the UK demonstrated that there is a decrease in supply chain costs associated with sub-contractors cash flow certainty and a reduction in finance costs.

The 2015 Senate Economics Committee inquiry into insolvency in the construction industry recommended the trial of PBAs on Australian Government construction projects. For example, the use of a PBA would have prevented a number of sub-contractor insolvencies related to the insolvency of one of the main contractors of the Chifley Building in Canberra. The appropriate payments would have been quarantined and made available to the sub-contractor's when the contractor became insolvent. The UK, Western Australian and Queensland governments have moved to implement project bank accounts on government construction projects.

Whilst government policies impact the direct suppliers they are not extended down through the supply chain. Governments must establish mandatory conditions to tender for procurement for businesses to maintain payment practices in their supply chains which are equal to or better than the governments. The benefit of government procurement spend will then flow through the whole supply chain. This was a key lesson learnt from the US QuickPay initiative which yielded significant benefits in jobs and growth. A similar approach has been adopted by the UK government to flow payment times through the supply chain.

The benefits of government spending should be directed to businesses which share those benefits along its supply chain, act responsibly and seek to grow their business as well as the Australian economy. Linking better payment times as a condition of tender will highlight a government's commitment to ensuring the value of public spending is maximised.

It is recognised there will be a series of one-off costs to governments to increase working capital in order to pay faster as well as one-off implementation costs related to changing processes and systems. These costs will be offset by the benefit to all businesses in government contract supply chains in relation to savings in financing costs as a result of being paid faster.

Governments have a responsibility to spend public money prudently, seeking to obtain the best value for money outcome in any procurement exercise. By not setting a shorter timeframe governments are not maximising the wider economic benefit and value potentially achieved through their expenditure.

This is also relevant to ensure the procurement practices and policies of governments are as efficient and effective as possible. Governments can build more effective systems to handle procurement payment processes through the benefits of electronic invoicing (currently under consideration by the industry-led Digital Business Council) and vendor management tools.

Industry codes to include payment times and practices

Recommendation 7: Industry codes which regulate business to business transactions to include best payment practices including set payment times.

Rationale:

- Voluntary and mandatory industry codes set out industry standards of conduct and are well placed to mandate each industry's agreed payment practices.
- Incorporating payment times in existing codes allows each industry to develop best payment practices for the participants in that industry.
- Incorporation of payment times will increase transparency of payment practices for existing and new entrants to that industry.

Inquiry research

Where industry participants have a code which regulates interactions, or are seeking to develop one, the inclusion of expressed payment times and practices will assist all industry participants. It does this by setting out industry agreed standards and practices and provides certainty for participants around which they can operate their business.

There was significant interest amongst larger businesses and industry bodies in developing a voluntary industry code for payment practices. This inquiry is not recommending the development of a national voluntary payment code instead recommending a legislative approach to maximise the effectiveness of industry specific codes.

The Ombudsman welcomes the proposed initiative by the Business Council of Australia for a payment code along the lines of the UK and Irish codes. Such codes 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 form of compensation;
- regular reporting to an independent external, possibly Government, body (such as ASBFEO, subject to funding); and
- a compliance and enforcement mechanism.

Individual industry codes allow the specific nuances of payment practices relevant to that industry to be codified and captured. A code provides transparency of the accepted standards and payment practices to both industry participants and prospective entrants.

While codes are a good first step overseas experience has shown their effectiveness is limited. Voluntary measures to address poor payment practices do not compel businesses that have extended payment terms or late payment practices to change. The UK experience shows that its voluntary payment code was adopted by large businesses which sought to promote prompt payment behaviours. It is of no surprise that these businesses were not the source of late or extended payment practices. Businesses which signed up to the Code did so as they recognised the importance of their suppliers to their products and success.

To assess the effectiveness of an industry code regular reporting to, and monitoring by, a body independent of the industry is required. Monitoring would need to be against both the benchmarks set by the industry and the minimum acceptable standards established by the monitoring body. Such independent reviews will build a body of evidence on the effectiveness of the code and the impact of payment practices through the supply chain.

Legislate the acceptable standards for Australian business payment times and practices

Recommendation 8: The Australian Government to introduce legislation for larger businesses to publicly disclose all of their payment times and practices and performance against those terms. Larger businesses being the top 100 listed on the ASX and multinationals.

Recommendation 9: The Australian Government to introduce legislation which sets a maximum payment time for business to business transactions. Certain industries may need terms greater than maximum which can be agreed providing they are not grossly unfair to one party. Where a longer terms is called into dispute it will be considered an unfair contract term.

Rationale:

- Increasing transparency around business behaviour and practice with regards to late payments and extended payment times exposes bad practice.
- Transparency enables suppliers to make an informed choice regarding customer payment behaviour when accepting a new customer.
- Public information allows critical review both internally and externally.
- Experience from overseas shows that voluntary codes do not compel businesses that have extended payment times or late payment practices to change.
- Setting a maximum payment time contract term will limit extended payment times in business to business transactions.
- An explicit maximum payment time provides certainty for businesses to structure and manage their working capital.
- Business will meet legislative requirements for the conduct of transactions.

Inquiry research

The growing trend in Australia for extended payment times will impact the economy as it slows down the flow of cash through supply chains and raises costs for businesses which are financing longer trade credit to their customers. Additionally, late payments further add to the cost of transactions as businesses are forced to spend time and money to chase late payments or write off the amounts as bad debts.

As experienced by overseas governments, for example in the UK, voluntary measures were only adopted by businesses which already had good payment practices. This was echoed in our research with larger business. Respondents who participated recognised the importance of prompt payment to their suppliers in enhancing their brand and their own customer's experiences. Similarly, there can be a competitive, working capital costs for early adopters of voluntary prompt payment practices. In highly competitive markets, this can be exploited by competitors and market commentators which examine company performance rather than economic benefit.

With voluntary measure having minimum impact the UK moved to legislation, most recently, the duty to report payment times and practices.

The need for legislation to require business to disclose their payment times and performance leads to an increase in transparency as it shines a light onto the culture and practice of the individual businesses. This should be reported publicly to an independent, possibly Government, body (such as ASBFEO, subject to funding). This will highlight those whose practices do not match the stated payment terms, the reality experienced by their suppliers.

Transparency will enable any business to assess the value of a potential customer against the risks arising from its bad payment practices, provide governments the means to assess the corporate behaviour of large businesses and force the executive and board members to be aware of how the practices of its accounts department impact the reputation of the businesses. As experienced in Spain, businesses must report publicly their payment behaviour compared to the legislated benchmark and has seen, where it fails, an increased focus and commitment from company directors to improve.

There was little support for a legislated solution in our consultations with peak bodies and large corporations which claimed this would create a significant cost burden and result in excessive regulation.

Yet the majority of businesses, especially large business, already collect and report on aspects of payment practice as part of financial reporting. Working capital management is increasingly an important part of a large business administration and is actively managed from a corporate perspective. Similarly, executives are frequently measured on key performance indicators that include cash flow based indicators.

These elements already exist in large business and it is not considered a significant additional cost would be incurred to report the same information publicly.

However, public reporting and monitoring alone will not compel the worst offenders to adopt shorter payment times, nor necessarily improve their payment practices.

Where law does not exist there will be exploitation of the gap. When extended payment times, late payment practices are taken too far they have a detrimental impact on supply chains and on the economy. Legislation is required to change poor practices. This is a well-documented phenomenon in the corporate tax environment which the Australian Government actively seeks to address through legislative measures.

Therefore the Australian Government must legislate a maximum acceptable payment time for business conducted in Australia. It is acknowledged that certain industries may need terms greater than this. Longer terms could be agreed providing not grossly unfair to one party. Where a longer term is called into dispute it will be considered an unfair contract term.

We recommend the Australian Government legislate in a phased approach. The first step is to require disclosure of payment terms and performance against those terms. This will raise the profile of practices and provide a complete picture of the extent of the practice. The second phase of the legislation is for the Australian Government to set a maximum payment time. In doing this the Australian Government will set the standard of what is considered an appropriate upper limit on payment times for businesses operating in the Australian economy.

The approach to legislate a maximum payment time is not intended to interfere in the freedom to contract between parties. The Ombudsman seeks to streamline red tape in business and to this end this legislative approach should be aligned with existing unfair contract legislation and other corporate and commercial laws which seek to create a framework for business to business transactions. Experience from overseas jurisdictions show the wider economic benefits outweigh the regulatory impost. The EU estimates each day of reduction in late payment times saves European companies approximately €158 million in financing costs.

Using technology to build better paid businesses

Recommendation 10: Governments should encourage the adoption of technology solutions, such as e-invoicing, to assist business to streamline administrative tasks and facilitate payment practices.

Rationale:

- Late and incorrect invoicing, poor administration and communication are leading reasons why businesses don't get paid on time.
- There are a range of technology solutions that can assist businesses with managing their business and facilitating payment practices. This includes accounting platforms, mobile payment platforms and e-invoicing.
- Government should continue to extend support for business to adopt technology solutions such as the instant asset write-off and education/advisory services to maximise their application.

Inquiry research

Data from larger businesses indicate that the leading causes of late payment are incorrect invoices, followed by disputes over quality and delivery of products. Survey data also shows that businesses prioritise prompt and correct invoicing and active communication as the leading techniques to address late payments.

Whilst there are a number of sophisticated businesses operating in the Australian economy there are a large number of businesses which can improve their practices through better administration, prompt issuing of invoices and improved communication.

There are an increasing range of technology solutions which can assist business to administer their business, manage finances and communicate with suppliers and customers alike. Appropriate use of technology solutions can enable a business to streamline the non-core aspects of their business to be more time efficient.

A number of submissions made by financial technology companies outlining the challenges facing business highlighted how their individual product (or range of products) supports business in addressing those challenges. For example, there are software packages available which electronically record core customer details, generate and send invoices and send automatic reminder notices when payment is due. Other systems facilitate back end payments processing or provide a mobile and web-based payment facilities.

Similarly, larger businesses can also benefit from the uptake of technology to facilitate interaction with suppliers through supplier procurement systems which provide a range of features. These include automatic invoice generation, invoicing tracking and streamlined processes for interacting with the appropriate areas of the organisation. While the benefits of using these systems flow to both supplier and customer, the cost of this should not be rest solely on the supplier. Larger businesses passing on the cost of using these systems (such as online supplier management portals) was reported in submissions as adding to the cost of supply.

Governments can support adopting technology solutions and empowering businesses to become more efficient and productive. This can be achieved through extending tax incentives, such as the instant asset write-off, and raising the awareness of these incentives among businesses. Government can also extended incentives to include education, training and business advice for maximising the application of technology.

Separately, the Australian Government should seek to expedite the Digital Business Council's work on e-invoicing to ensure the appropriate standards and infrastructure is ready for Australian businesses to take up e-invoicing on a wide scale.

ASBFEO Action items

The Payment Times and Practices Inquiry has highlighted the need for continued action on the topic of payment times and practices following the conclusion of the Inquiry.

To this end the Australian Small Business and Family Enterprise Ombudsman has taken several action items to continue advocacy on the topic. This includes:

- Developing a National Payment Transparency Register to publish businesses payment times and practices rated against a benchmark for good and bad performers.
- Work with ASIC and other agencies on extending measures to increase the awareness of the need for business to manage working capital through targeted programs.
- Research access to justice issues for businesses to develop a process for quick (within 14 days of lodging) determination of liability in relation to non-payment of supply.
- Contributing information from the Inquiry concerning payment issues in the building and construction industry to the Murray Review into security of payments legislation.
- Working with the appropriate government agencies monitoring trade credit in the economy with a view to examining the role of trade credit on growth in the Australian economy.
- Engaging with the appropriate government agencies to examine avenues to improve government procurement and payment practices.
- Examining the feasibility of establishing a National Small Business Register to allow business to self-identify themselves for government and commercial activities.
- Working with the Australian Competition and Consumer Commission to review payment times and practices by industry against the unfair contract terms legislation.

National Payment Transparency Register

The Australian Small Business and Family Enterprise Ombudsman proposes, subject to funding, the development of a public register which highlights good and bad payment practices by Australian businesses.

The register could be developed and managed by the Ombudsman and will collect information on the payment practices of businesses. Businesses will be listed on the register according to specified criteria and following an assessment procedure based on evidence provided by other businesses.

Businesses identified for listing will be provided with an opportunity to respond to information provided prior to public listing.

The naming, “Praise or shame”, approach will ensure the best and worst practices of businesses are identified and brought to the attention of the industry, government, the media and general public.

The Ombudsman will work with other government agencies, where appropriate, on sharing information collected by the register regarding business practices which could be used to improve the design of policy and regulatory outcomes, including legislation.

Improving small business financial literacy

It is a well known saying that “cash is king” to represent the importance of cash flow to business and personal finances.

Despite this, Australian Bureau of Statistics data shows that approximately 2 in 5 businesses do not survive past 4 years of trading. There are many reasons as to why these businesses do not survive including a lack of planning and capital. Businesses operate on cash and customers, knowledge of how to maximise both is critical to ensuring sustainability.

There is significant work being undertaken to improve the financial literacy of Australian’s under ASIC’s national financial literacy strategy. The strategy recognises that improving the financial literacy of Australians is a generational task. There is significant focus on consumer and individual education in this space however there is the potential to expand the range of education to new and small businesses.

ASBFEO will approach ASIC and other appropriate agencies to examine options to increase awareness of the importance of working capital, particularly for new businesses. This could include linking “nudge” measures at business registration, such as a new businesses registration being required to indicate its level of awareness of its cash flow requirements through completion of a financial literacy programme. Similar requirements could become part of business lending.

There is also potential to expand support for programs like the ATO’s Cash Flow Management Education Program which uses trusted advisors to deliver the education.

Access to justice - a low cost, fast, enforcement processes

In general, businesses do not chase outstanding debts under $10,000 as the costs (including legal and administrative costs) are often greater than the debt amount and the time to recover the debt offsets any possible benefit to cash flow.

Part payment, late payment and non-payment are sources of outstanding debt which frustrate businesses and consume significant administrative resources.

Depending on the size of the outstanding debt the available legal remedies such as existing small claims tribunals and the courts require legal resources, significant time away from the business and financial capacity to operate while waiting for an outcome.

A minority of businesses exploit the difficulty in chasing payments through legal avenues. In addition, the presence of “zombie businesses”, that is, businesses that are in trading difficulty and are close to insolvency due to indebtedness. These businesses trade close to insolvency by delaying payments to other businesses prioritising other costs such as interest payments to banks.

ASBFEO will research access to justice issues including examining the feasibility of developing a process for small business to receive a quick (within 14 days of lodging) determination of liability in relation to non-payment of supply. Options to be explored include online dispute resolution, arbitration or extended powers of an existing body to make a determination within a certain timeframe. The process should focus on simple, non-legalistic solutions.