Businesses must plan for rising default rates, insolvency risk | Accountants Daily

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BUSINESS

The full impact of rate rises has yet to flow through the economy so now is the time to prepare for the worst, says CreditorWatch.

By Philip King•25 July 2023•1 minute read
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Insolvency risk management should be core to business operations because default rates will rise steeply as mortgage holders come off fixed-rate loans, according to the latest CreditorWatch data.

It said external administrations have returned to pre-pandemic rates and defaults will hit 5.8 per cent this financial year so businesses need to actively minimise risk exposure.

“FY24 will be difficult for Australian businesses and consumers,” CreditorWatch chief executive Patrick Coghlan said. “By September 2023, the full impact of the RBA’s 12 cash rate rises will have been passed on and it’s going to affect about 40 per cent of Australian households. In the second half of this calendar year, we have more people moving off fixed rates than in the first half.

“So there’s going to be a tremendous amount of pressure on the consumer and business wallets.

“We are all paying a lot more for goods and services, consumer confidence is at record lows and business confidence isn’t doing that great either.”

CreditorWatch’s *Safeguarding Your Business Insolvency* report highlighted rising insolvencies, particularly for the construction and retail trade industries, and drew together insights from experts in the field.

Australian Institute of Credit Management CEO Nick Pilavidis said businesses needed to actively shape four areas to minimise risk, starting with personnel.

“The more experienced and qualified your credit team is the better they will be able [to] use data, technology and best practice policies to support customers and mitigate risk of slow and non-payment,” he said.

Systems and data were another focus and organisations that had invested in technology over the past two years had outperformed, according to AICM data.

“Those systems free up the credit professionals’ time to have conversations with customers and target efforts on those that can’t pay,” he said.

Also vital were regular conversations with customers, especially those at risk, to understand what was happening.

“Find out how you can do business with them and establish which businesses present greater risks and see if these can be mitigated,” he said.

Cathro & Partners principal Andrew Blundell said being alert to the early warning signs of insolvency was critical to making informed decisions about whether to provide credit.

Key indicators included accounting regularities such as overvalued assets or goodwill, a lack of capital investment, dividends exceeding performance, and management resignations. Analysis of cash flow could throw up obvious issues such as reduced cash balances, maxed-out credit limits, or inability to maintain terms with suppliers.

He also highlighted related party loans as an increasingly significant problem.

“Over the past three years, directors’ behaviour has changed as external parties have been less focused on recoveries and more focused on supporting their clients,” Mr Blundell said.

“Many directors have become used to the lifestyle that they’ve been able to lead over that period and it’s not uncommon to see substantial related party loan accounts listed on balance sheets that come across my desk.

“The collectability of these is really what needs to be considered as well as their classification, which may have a material impact on the business’s working capital position and could materially affect your decision to extend credit.”

GM Advisory services director Ginette Muller offered tips for dealing with a customer who appeared to be spiralling into insolvency. One question was whether to negotiate or pursue litigation.

“Litigation does not always result in the outcome that you’re looking for and is time-consuming and costly with no guarantee of success,” she said. “Maybe you’re better off negotiating with the debtor even if that risks receiving a preferential payment.”

If a business did enter formal administration, creditors seldom got a great outcome from either voluntary liquidation or administration with liabilities often written off. Formal small-business restructuring, however, kept a business trading and some creditors would continue to be paid.

And she said every business should have a plan for the possibility that an insolvent customer could threaten its cash flow.

“What happens if my customer’s going broke and this has a domino effect on me?” Ms Muller said.

“So now you’re in jeopardy. The important thing here is to start to think about implementing a plan. What’s my process? Who do I need to go and see? What help do I need? Do I potentially need some safe harbour protection while I’m working through this process?”