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Managing credit risks when dealing with SMEs

By Colin Porter*

By anyone's count, the Australian business landscape is dominated by small and medium enterprises (SMEs). According to the ABS, there are approximately 2 million of them. Indeed, were you to pick an Australian business at random, you'd have a 96 per cent chance of choosing an SME.

For credit managers, this means that extending credit to businesses much smaller than their own is routine. It's therefore a worthwhile exercise to consider the state of the SME space, the particular challenges it brings, and the tools that can assist with better credit decisions.

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Why focus on SMEs

While the amount of credit extended to SMEs is often relatively small, it's important to understand that in comparison to corporate debtors, SMEs are a bigger risk.

As is often said, SMEs are the 'engine room' of the Australian economy, but they're also inherently more fragile than big businesses – with everything from poorly managed cash flows to their own bad debtors capable of sending them to the wall.

As smaller entities, they're also more exposed to the broader state of the economy – and they're often the first to succumb to downturns in economic activity.

The SME sector has a high rate of non-payment disputes. A 2010 Department of Innovation, Industry, Science and Research report found that around one in five of small businesses had had a dispute with another business since 2005, with 45% of these concerning unpaid bills. The Council of Small Business of Australia (COSBOA) insists that after under-reporting is taken into account, the real figures are much higher.

Right now, additional factors are putting SMEs under extra stress. Not only are many struggling to obtain finance, the Australian Taxation Office is cracking down on SME tax obligations. ASIC says that insolvency practitioners are citing the ATO's tighter policies as a contributing factor to the 21 per cent jump in insolvencies recorded in June of this year, a month in which 1,027 companies entered external administration. That result was the second worst since records have been kept, with the construction (24 per cent), services (22 per cent) and retail sectors (10 per cent) worst hit.

The point is that a dollar given in credit to an SME is a dollar loaned at a higher risk. Managing this risk is therefore a vital part of managing an overall ledger.

The trouble with managing SME credit

For credit managers, the SME space is a particular challenge for two reasons.

The first is the sector's size. With millions of businesses making millions of transactions a day, there just isn't the same depth of monitoring and reporting as there is at the big end of town.

The second problem is under-reporting. The unfortunate fact is that small companies generally don't report bad debts – either because they lack awareness of how to go about it, don't have access to the right tools, or the costs are out of reach. Instead, their first thought is often to take the debt to a small claims tribunal or a debt collector, acts which don't always produce successful results.

This situation means that credit managers have little to no early-warning system when it comes to SMEs.

To date, businesses typically ask SMEs for trade references while performing checks through large credit reporting bureaus. This has provided ample opportunity for risky and poorly performing SMEs to fly under the radar.

Dealing with SMEs

- **The SME sector is volatile and exposed.**
- **SMEs in trouble often attempt to hide by first defaulting on SME creditors, leaving corporates in the dark.**
- **SME peer-to-peer bad debt reporting can provide an early-warning radar.**
- **Pay careful attention to SME clients in industries known to be struggling.**

SMEs usually default on their corporate and bank debts *last*. Check any administrator letters sent to creditors of a failed SME, and you'll find that the majority of businesses owed money are also SMEs. That's no accident. Many poorly performing SMEs try to hide their financial woes by defaulting on smaller creditors first, knowing that they are unlikely to take legal action or report the default widely (as many SMEs don't participate in credit reporting bureaus).

It's not until an SME defaults on a corporate creditor or bank who is able to take action and make a default report with a credit reporting bureau that other corporate and bank creditors become aware that the SME is in financial distress and that they too could be exposed to a bad debt.

New tools

There is good news for credit managers dealing with SMEs, however. A new service has entered the market to specifically enable credit reporting on small and mid-sized businesses.

At CreditorWatch, we've seen strong uptake among SMEs in our network which brings small and mid-sized businesses together to watch and monitor each other's payment histories, with thousands of businesses now monitored by their peers. We're also making our service more comprehensive, with the introduction of court judgements and other data streams.

While it's not aimed at the corporate sector per se, we believe that, used alongside large credit reporting bureaus, CreditorWatch offers credit managers the chance to identify risky SMEs faster. The service short-circuits the ability of non-payers to hide their financial woes through the provision of shared intelligence about poorly performing SME debtors.

As credit professionals know, better credit decisions are made with better information. By keeping watch on the information generated by the SME community, corporate creditors are more likely to see problems as they emerge and are able to take action to limit their exposure. It's a good first step towards removing some of the risk of engaging with this volatile sector.

*Colin Porter is the founder of CreditorWatch.com.au, a commercial credit reporting bureau where SMEs share information about bad debtors to make better credit decisions.