Ending late payment

PART 1: TAKING STOCK

About ACCA

ACCA (the Association of Chartered Certified Accountants) is the global body for professional accountants. We aim to offer business-relevant, first-choice qualifications to people of application, ability and ambition around the world who seek a rewarding career in accountancy, finance and management.

Founded in 1904, ACCA has consistently held unique core values: opportunity, diversity, innovation, integrity and accountability. We believe that accountants bring value to economies in all stages of development. We aim to develop capacity in the profession and encourage the adoption of consistent global standards. Our values are aligned to the needs of employers in all sectors and we ensure that, through our qualifications, we prepare accountants for business. We work to open up the profession to people of all backgrounds and remove artificial barriers to entry, ensuring that our qualifications and their delivery meet the diverse needs of trainee professionals and their employers.

We support our 170,000 members and 436,000 students in 180 countries, helping them to develop successful careers in accounting and business, with the skills needed by employers. We work through a network of 91 offices and centres and more than 8,500 Approved Employers worldwide, who provide high standards of employee learning and development.

This is the first of a series of three reports on the problem of late payment and how businesses and governments can work together to alleviate it.

It combines an extensive literature review with quantitative data from ACCA's member surveys to correctly define late payment, trace its precise origins and document its impact on the global economy.

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Introduction

In 2014, ACCA conducted a review of the widespread problem of late payment, a life-threatening challenge for many businesses globally. This review bought together recent ACCA research with the experience of ACCA members and other finance professionals to examine potential solutions.

The outcomes of this review have been presented in three reports.

- *Ending Late Payment, Part 1: Taking Stock* combines an extensive literature review with quantitative data from ACCA's member surveys to correctly define late payment, trace its precise origins and document its impact on the global economy.
- *Ending Late Payment, Part 2: What Works?* brings together a wealth of ACCA-commissioned publications and other research as well as 36 case studies involving ACCA members around the world to help define good practice in business and policy.
- *Ending Late Payment, Part 3: Reflections on the Evidence* summarises ACCA's findings and issues a call to action for governments, financial services firms, large corporates and small businesses.

Late payment is a fact of life for the majority of the world's formal businesses. It helps some survive against the odds, but it also threatens others. It is at once a sign of distress from the weakest businesses and a privilege exercised by the most powerful. From a macroeconomic perspective, it is both inefficient and potentially destabilising.

Professional accountants around the world lead the fight for prompt payment, ensuring that businesses are protected from customer defaults and can cope with interrupted cash flows. Their first-hand accounts can offer both business and policy audiences valuable insights, and none more valuable than those of ACCA's globe-spanning membership. From sectors and regions where late payment is endemic to the few places where businesses and governments have managed to turn the tide, the ACCA membership has, collectively, seen it all.

This report reviews the evidence ACCA has collected over the years on the fight against late payment, from member surveys to policy publications and academic research. Its aim is to support a correct understanding of the nature and origins of late payment, and make realistic recommendations to businesses and governments. To achieve this, it incorporates a detailed discussion of that most under-reported financial market of all – the multi-trillion-dollar market for trade credit, on which so much of the world economy depends.

ACCA is particularly grateful to all the members who contributed to this report through their responses to the ACCA–IMA Global Economic Conditions Survey from 2009 to 2014. Their first-hand accounts have helped fill critical gaps in the evidence on late payment and made this report possible.

1. Trade credit as a financial market

A very large share of business-to-business trade makes use of trade credit – that is to say, payment is not made at the time when goods or services are delivered, but rather at a later date, usually agreed in advance by the two parties. Atradius (2014) provides estimates of the prevalence of credit sales for different countries, ranging from 29% in Switzerland to 66% in the Czech Republic, but 40%–50% is typical across regions. In a world whose financial press is dominated by the affairs of the banking sector it can be easy to underestimate the size of the trade credit market, but it is very substantial nonetheless. As a rule, SMEs around the world receive more short-term credit from suppliers than from banks, and research for ACCA by Camerinelli (2014) suggests that a total $2.7 trillion of gross unconsolidated credit from suppliers (3.8% of world GDP) could be outstanding at any given moment in the supply chains of the world's biggest companies. Wilson (2014) estimates the total stock of trade credit outstanding on UK companies' 2012 balance sheets at just over £402 billion (26% of GDP), and the flows of trade credit at 1.2 times the flows of bank lending to companies.

Credit is not a trivial feature of transactions; it is as central to them as price or quality, and it allows much more business to take place than would be possible in a pure cash economy. Most importantly, trade credit is a financial service provided by suppliers to buyers. As Boissay and Gropp (2013) demonstrate, credit tends to flow from those with easier access to finance to those that are more credit-constrained, and firms provide each other with an important liquidity insurance service through trade credit. More generally, any business that sells on credit is, to some extent, a credit intermediary – similar to a small, unregulated, and rather under-resourced bank.

Major studies such as that of Martínez-Sola et al. (2014) demonstrate that trade credit is profitable for suppliers, while Ferrando and Mulier (2012) find that firms on both sides of the transaction actively use trade credit to both finance and manage their growth. Finally, studies such as Kalemli-Ozcan et al. (2013) suggest that trade credit helps make long, specialised supply chains sustainable by giving participating firms a stake in their collective success – each firm's receivables are, in one sense, its equity stake in the entire supply chain.

This does not mean that trade credit is a long-term substitute for bank credit. As Love et al. (2005) show, in the medium term the supply of trade credit is constrained by the amount of bank and other commercial credit; a financial crisis might trigger a run on suppliers in the short term but this will not produce a recovery in overall business financing. Even from the perspective of an individual business, studies (eg Du et al. 2012) show that trade credit alone can rarely fuel sustained business growth. Finally, as a country's financial institutions develop, the relationship between bank credit and trade credit from suppliers becomes increasingly complementary (Couppey-Soubeyran and Héricourt 2011) and the reliance on trade credit as means of managing growth becomes smaller (Ferrando and Mulier 2012).

From the perspective of ACCA's Four Inputs Framework on access to finance (ACCA 2014a), trade creditors can take on risks that banks would not want because a) they have superior information about the businesses they work with, as a result of daily interaction; b) they can exercise greater control over trade debtors than a financial institution can by threatening to withdraw their services; c) they can use their own goods and services as collateral in the event of default and d) they are secure in the knowledge that, unlike a bank loan, trade credit and goods sold cannot be easily diverted to uses other than the one intended.

Research certainly confirms the information advantage of suppliers: banks take information cues from creditors, and businesses struggling to obtain trade credit are more likely to be turned down by banks than similar businesses free from such problems (eg BDRC 2014). International research commissioned by ACCA (Forbes Insights 2011) and a wealth of UK evidence (ACCA and CBI 2010; BDRC 2011) also confirm that trade credit is the easiest type of external finance for businesses to obtain, all other things being equal.

The changing structure of industry is now also working in favour of trade credit as a source of short-term finance. As the business populations of developed countries become more services-based and intangibles-heavy, individual businesses become smaller and more virtual, and financial sectors continue to deepen, receivables are growing steadily as a share of SMEs' business assets. In the UK, for instance, Wilson (2014) shows that trade creditors accounted for 86% of all micro-company liabilities in 2012, while small and medium-sized businesses depended on trade creditors for around 69% and 39% of their liabilities respectively. In all cases official data recorded an upward trend (up from 74%, 59% and 32% respectively in 1998), and this persisted across all sectors. Only among companies with 250 or more employees was there no such trend – the percentage was more or less fixed, rising only from 20% to 21%.

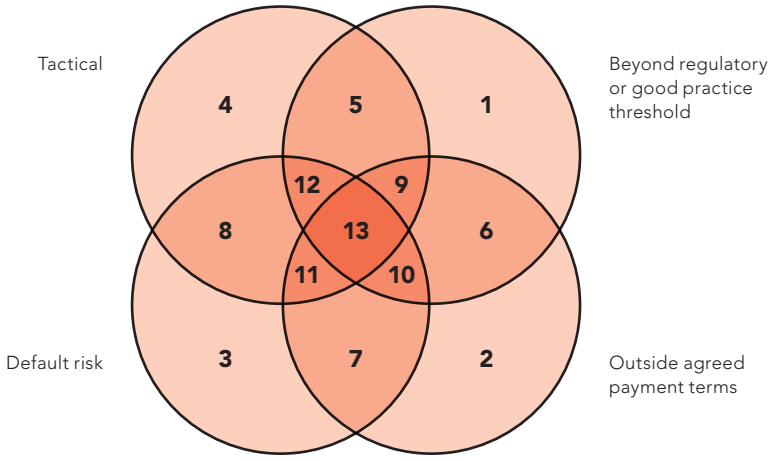
2. Defining late payment

Clearly, not all credit sales are settled promptly – but those that are not cannot be easily grouped together. It is easy to understand the term 'prompt payment' as payment at a time and in a manner that broadly fits both the supplier's and the customer's preferences and expectations. Its opposite, however, is much harder to define; there are many ways of paying 'late'. Because 'late payment' does not correspond to a single reality, and the term's use is inconsistent between policymakers, business representatives and the public, policy responses will tend to be incomplete, poorly designed, and likely to achieve too little.

Overall, in order to classify and define deviations from prompt payment, policy should take into account four considerations (see Figure 2.1).

- Is the supplier paid within the contractually agreed period?
- Regardless of (1), is the supplier paid within a 'good practice' period specified by law, standard industry practice, or a widely accepted standard, eg a 'prompt payment' code?
- Is the customer a default risk? How certain is it that the supplier will be paid at all, and what share of outstanding debts are likely to be paid given default?
- Is the supplier's payment behaviour dictated by necessity/chance or is it a choice motivated by tactical considerations?

Figure 2.1: The late payment universe: deviating from prompt payment expectations



Key to Figure 2.1

1. Industry-standard credit terms that are long by the standards of other industries
2. Routine administrative delay or dispute
3. Low-probability provision for bad debt
4. Routine de-prioritisation of suppliers (no dilution)
5. Extended terms or prompt payment discounts demanded by a dominant buyer
6. Non-routine administrative delay or dispute (with potential for legal recourse)
7. Short-term forbearance/major invoice dispute
8. High-probability provision for bad debt
9. Extended terms or prompt payment discounts demanded unilaterally by a dominant buyer; tactical invoice disputes (with potential for legal recourse)
10. Medium-term forbearance/protracted major invoice dispute
11. Late payment with supplier dilution
12. Extended credit terms with potential supplier dilution (including provisions for bad debt and potential for legal recourse)
13. Buyer default in bad faith.

Clearly, the complete universe of alternatives to prompt payment expectations includes several possibilities that would be unlikely to qualify as 'late payment' under any definition, but must be provided for in contracts, accounting practices or even explicitly in the law in order to ensure the good working of the credit market. For example, provisions for bad debt (instances 3, 8 and 12) are accounting treatments as opposed to actual credit events; accounting standards ensure that these are applied in a relatively consistent way, allowing investors to make informed decisions about companies' value and viability.

The universe of prompt payment alternatives also includes instances of credit terms that are longer than for most industries but nonetheless usual within a specific sector, and freely agreed by both parties, and adhered to by customers. This kind of 'no-fault' extended credit terms (instance 1 above) is, generally speaking, not problematic and should not be easily aggregated with other types of late payment. This is especially true of industries such as construction or the extractive industries where payment can be substantially delayed, and is often contingent on delivery or completion. In most countries, legal definitions of prompt payment rightly make concessions to industry norms, as these can help establish whether an individual buyer has knowingly treated a supplier unfairly or whether its behaviour is unreasonable.

The potential for supplier dilution occurs whenever default risk meets tactical behaviour, meaning that some suppliers are effectively treated as senior by the buyer (instances 8, 11, 12, 13). It becomes a material risk once agreed terms have been breached (instances 11 and 13). Supplier dilution is important because it disproportionately affects the real economy: suppliers of essential services such as utilities, or those with greater enforcement/ collection capabilities (such as banks, landlords or government agencies) will tend to be prioritised by customers at risk of default. Any regulation or internal credit policy that does not take into account the risk of dilution is bound to prove incomplete when put to the test.

Forbearance is a common response to late payment, whereby a customer in breach of credit terms is allowed to delay payment, or pay only in part, rather than default outright. The creditor thus hopes to maximise the net present value of its claim by allowing the customer to continue trading and continue to generate cash flows, but accepts a higher default risk and cost of capital (instances 7 and 10). The banking sector has a long history of using forbearance, often to good effect, and so do suppliers in the real economy. Evidence from the experiences of both sectors can help inform the treatment of forbearance in accounting and risk management, as well as in policy.

As a rule, instances of late payment that are both outside agreed terms and outside a regulatory or good practice period (instances 6, 9, 10, 11, and 13 above) are the easiest to challenge legally; but of those only instances 6 and 9 are likely to be easily enforceable because the customer is clearly in breach of its obligations and able to pay; whereas all other instances involve a genuine element of default risk which means that the customer may be unable to pay in full. Instance number 6 (non-routine administrative delays or disputes) is likely to be substantially discouraged by regulation, as it is not motivated by the pursuit of commercial benefit, while combating instance number 9 (unilaterally imposed extended terms) will require significant investment in the suppliers' recourse and enforcement options. Regulators must ensure that SMEs, in particular, have realistic and cost-effective options for challenging unilateral contract changes and pursuing debts, so that regulation can act as a credible deterrent.

In principle, credit terms are part of a contract in the same way as prices; contractual credit terms should be binding on any parties that enter a contract freely, and governments should not seek to regulate the former any more than they do the latter. That said, unilateral changes to credit terms in established supplier relationships (instances 5 and 9) are not automatically justified by this principle.

Changes to credit terms with established suppliers can often be demanded before the nominal end of a contract that both sides expect to renew, and this is unlikely to be equivalent to demanding such terms from a new supplier at arm's length. Changing terms of credit can have severe cash flow implications for small suppliers, typically forcing them to apply for additional overdraft or other credit facilities, or explore alternative financing arrangements. By mandating a minimum notice period, policymakers can restore to the established supplier much of the freedom of choice that a new supplier would have. 'Sufficient notice' will vary between countries and industries, but ACCA's research suggests that it could range from one month in major developed economies to six months in emerging markets (ACCA 2014b).

Behind headline terms of credit there is often an implied equivalence of time and money; thus many buyers might be offered, or might demand, prompt payment discounts in return for paying within a given period (instances 5 and 9). Such discounts are economically equivalent to longer terms of credit if negotiated at the outset, or equivalent to late payment if imposed in mid-contract or as a condition of renewing a contract (a practice referred to sometimes as 'pay-and-stay'). Hence, throughout this report and the rest of the series, all references to late payment will implicitly also refer to the equivalent prompt payment discounts.

Finally, not all late payment involves invoices that the customer has agreed to pay. Invoices can often be disputed if the product or service delivered does not match the customer's expectations on, eg quality or timeliness, or even on spurious grounds in order to delay payment. It is not common for policy or industry guidelines to regulate invoice dispute practice (relevant to instances 2, 6, 7, 9 and 10), but transparency on such practices, can provide a useful tool in relieving some elements of late payment.[1]

1. As of December 2014, the UK government was consulting on proposals for mandatory disclosure of dispute policies. See BIS (2014).

3. Why do businesses pay their suppliers late?

Much of the press coverage and other lay literature on late payment treats it as a form of corporate anti-social behaviour – cash-rich corporates or unscrupulous traders taking advantage of small firms without the market power or the administrative capacity to oppose them. Although there is certainly an element of poor corporate citizenship involved in late payment (see eg Paul and Boden 2012) this emotive reading overlooks the true nature of the problem and can lead to both poor business practice and poor policy design.

Regardless of definition, late payment is 'a feature, not a bug' of the trade credit market; in at least half of all instances it does not involve long terms of credit and only rarely does it involve customers at risk of failure. Atradius (2014) estimates that at least 30% of all credit-based sales in developed and emerging markets are paid outside of the agreed terms, yet in each region only between 16% and 21% are paid more than 60 days after the invoice date, which was the maximum allowed terms of credit in the EU without an explicit agreement. Moreover, bad debts are consistently below 3% of the total at the regional level. Similarly, the International Chambers of Commerce (ICC) Trade Register (ICC 2014) has repeatedly stressed the relative safety of trade credit as an asset class, boasting default rates at 'a tenth of the Moody's rated universe [of debt-based securities]' from 2008 to 2012.

Table 3.1: Credit, extended terms of credit, late payment and defaults

	% of sales on credit	% of invoices paid more than 60 days after invoice/ delivery	% of invoices paid more than 90 days after invoice/ delivery	% of credit sales not paid on time	% of credit sales unrecoverable
Americas	43	18.1	12.6	38.4	2.7
Western Europe	42.4	21	12.7	37.6	1.7
Asia-Pacific	48.4	18.9	14.1	36.2	2.2
Eastern Europe	47.2	15.8	7.9	31.9	1.2
Turkey	47.7	31.3	20.4	44.4	2.2
UK	46.5	14.9	11.2	42.8	2.3
Singapore	51.5	15.2	9.4	41.5	2.4
India	42.6	25.2	21.6	40.4	2.9
Hong Kong	47.9	12.8	6.7	38.8	2.2
Indonesia	49.4	33.8	31.9	37.1	2.6
Ireland	43.1	28.7	21.3	35.7	1.5
China ex HK	38.4	17.4	13.2	34.3	2.5
Czech Republic	65.8	10.9	7.6	32.6	1.6
Poland	42.5	21.2	13.5	29.8	1.3

Source: Atradius (2014)

The simple truth is that what a supplier views as late payment is fast and free credit for its customers. Both requests for extended credit terms and payment later than agreed are essentially latent demands for cash.[2] Extended credit terms are the 'prime' version of such demand, whereas late payment is the 'sub-prime' version. It is important to remember that only a minority of businesses actually plan to pay their suppliers later than agreed. ACCA and CBI (2010) find that in the year covered by their report, only 9% of UK SMEs planned to use late payment as a form of finance in the coming year, whereas 24% expected to ask for extended terms of credit. The research found that late payment was part of a group of sub-prime financing tools, alongside loans from directors and asset-based finance from non-bank providers – a finding corroborated in other countries, such as Australia (Fitzpatrick and Lien 2013). According to ACCA and CBI (2010), all three of these sources of finance are substitutes for normal trade credit and bank loans or overdrafts – and as nearly nine out of ten attempts at late payment are successful, access to finance through late payment was substantially easier than getting bank credit. Ironically, and importantly, the chances of securing extended terms of credit with or without prior agreement were practically identical.

The 'sub-prime' status of late payment is evident in its strong association with weak cash positions – in the aforementioned study, weak cash flow increased the likelihood that a business would seek to pay late by 68%, twice as much as it increased its likelihood that it would seek a formal extension of the terms of credit. These findings are corroborated in emerging market studies such as de Carvalho (2014), which demonstrates that businesses with shorter-term liabilities and smaller and shorter cash cycles are more likely to pay late.

If late payment is explained by a customer's need for cash and its cash position, and assuming the customer does not represent a significant default risk, then to the supplier that tolerates late payment or extended terms of credit this represents a claim on the customer similar to preferred stock. The supplier essentially provides customers with a cash injection in exchange for a (weak) promise of regular business in the future, and the larger and faster-growing the customer, the more valuable this promise becomes. If the customer does represent a default risk, then tolerating late payment is an act of forbearance – aiming to maximise net recoveries by allowing the customer time to pay. Forbearance will become more attractive the more dependent a business is on its troubled customers, and the more likely the customer is to remain viable.

By looking at late payment as customers' demand for cash, as a supplier's quasi-equity claim on customers, or as supplier forbearance, it is easier to understand why regulating late payment out of existence is so difficult. In addition, this approach suggests that it might be undesirable, especially in a recession, to eliminate late payment altogether, as it would significantly reduce the supply of badly needed credit to businesses. Indeed, Connell (2014) finds that, during the recent financial crisis and its aftermath, late payment of commercial debts in the Eurozone periphery often supported business survival.

2. For a discussion of how this differs from demand for credit or money, see Coppola (2014).

4. The measure of the problem

Regardless of its precise definition, late payment is a common concern for businesses large and small: this is made clear by the findings of the ACCA–IMA Global Economic Conditions Survey (GECS), which tracks the proportion of finance professionals working in SMEs and large corporates reporting 'problems securing prompt payment' on a quarterly basis. These figures indicate that the typical incidence of late payment by customers during the recovery ranged from 21% to 43% across regions for large corporates and 28% to 56% for SMEs (Figure 4.1).[3] Estimates for ACCA by Camerinelli (2014) suggest that at any given time a total of $282 billion worth of payments late enough to be problematic for suppliers is outstanding in the world's major supply chains, representing over 10% of all trade credit outstanding – and that must be taken as a most conservative estimate of the true extent of the problem.

From a regional perspective, GECS data suggest that the incidence of late payment has typically been higher in Africa, South Asia and the Caribbean, and lowest in Asia-Pacific and North America, particularly for large corporates. As a rule, SMEs have clearly been more vulnerable to late payment throughout the 2009–14 period.

Fig. 4.1: Typical incidence of late payment reports by region, Q1 2009 to Q3 2014

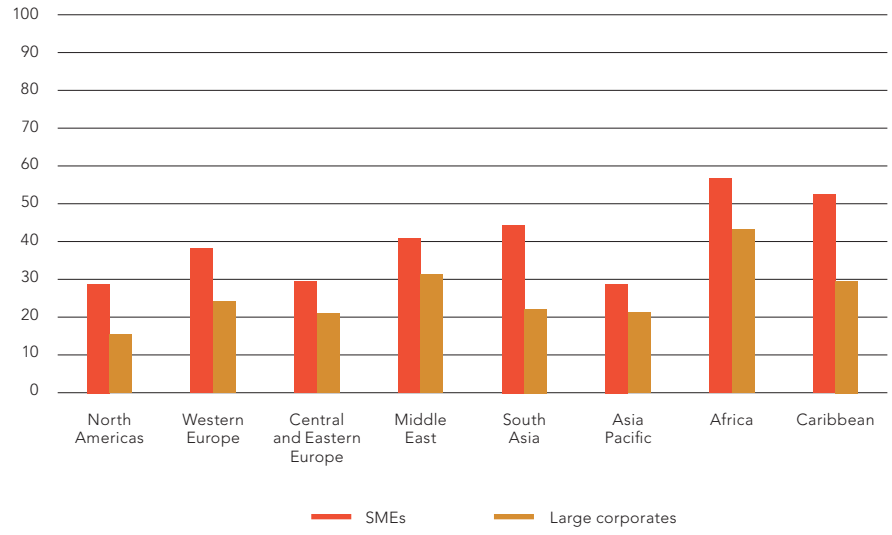
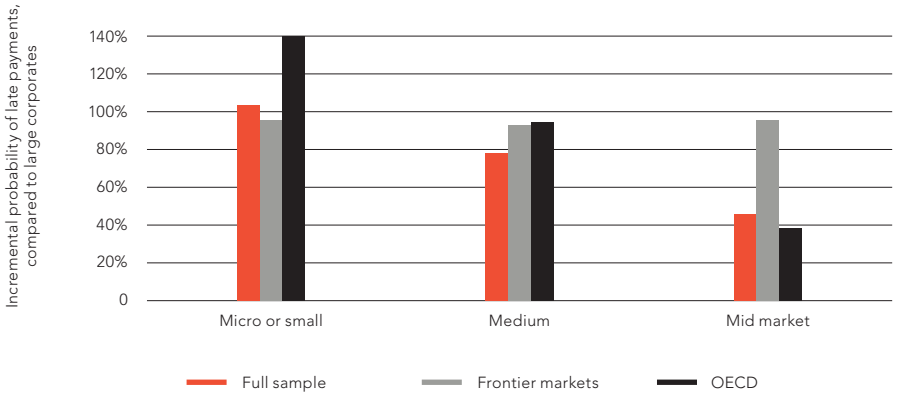


Figure 4.2: Late payment, business size and economic development



3. For the purposes of this report, the 'typical' incidence for a given quarter refers to the four-quarter moving median percentage of businesses in a region reporting 'problems securing prompt payment'. The typical incidence across the whole time series is the median of all moving medians from Q4 2009 onwards. While GECS does not provide a definition of late payment, the phrasing corresponds mostly closely to what Chapter 3 above refers to as payments 'outside agreed terms'.

These headline findings are confirmed by a more rigorous analysis. After controlling for a wide range of other possible influences,[4] small and micro enterprises are more than twice as likely as large corporates to be affected by late payment (see Figure 4.2), and some of this 'size penalty' persists among larger size bands. In addition, the penalty for small businesses becomes larger as countries become more developed – in OECD countries it is more than twice as large as in frontier markets[5] for all businesses below 250 employees. One reading of this result is that small businesses miss out on a lot of the improvement in cash-flow conditions that comes with economic development, as their access to finance and ability to enforce contracts, as well as their ability to secure viable customers, will tend to remain constrained; the small business sector is, in one sense, always an emerging market.

In addition to varying between regions, the incidence of late payment has also varied significantly over time, as demonstrated in Figures 4.3 and 4.4. Late payment is neither random nor strictly cyclical, however, because it is driven by combinations of the following five factors:

- businesses' working capital needs, which are in turn driven by new orders and input price inflation
- access to short-term credit from banks and other intermediaries
- access to liquidity at the top of supply chains, and by implication in the capital markets
- business indebtedness and interest rates
- business capitalisation, which is driven by retained earnings (or losses), bad debt and equity injections.

Each of these factors is most likely to drive late payment at different stages in the cycle: business capitalisation will tend to be correlated with access to finance and global liquidity, as will leverage and interest with working capital needs. As a result, in a recession businesses will tend first to risk bad debt then, in the recovery, they will risk overtrading. This explains why SMEs globally were just as threatened by late payment in early 2013, with a renewed recovery underway, as they had been in late 2009, as the world reached the end of a severe credit crunch (see Figure 4.3) (ACCA and IMA 2013). The impact of 'global' liquidity is harder to document, but factor analysis of the GECS data suggests that global liquidity levels explain about 30% of the quarter-on-quarter regional variation in cash flow conditions.[6]

4. These included business size, region, level of economic development of the country in which respondents were based, respondents' macroeconomic and fiscal policy outlook, respondents' role and gender, and the number and geographical distribution of the businesses' offices. These controls were introduced into a binary logistic regression analysis involving GECS data from Q4 2011 to Q3 2014, in which the incidence of late payment was the dependent variable. Role and gender were partly introduced in order to act as proxies for other unseen characteristics of the business. Responses were only used where respondents described their organisations as 'SMEs' or 'Large Corporates'; therefore all responses from practitioners, members in financial services, non-profits and the public sector have been omitted. The resulting sample contains just over 10,500 observations over 12 quarters.

5. For the purposes of this analysis, 'frontier markets' include all responses from South Asia, Africa and the Caribbean.

6. This analysis accounts for the total variation, throughout the period of Q1 2009 to Q3 2014, in four-quarter moving medians for the incidence of late payment, problems with access to finance, fears that suppliers will go out of business and fears that customers will go out of business, in each case with a separate time series for SMEs and large corporates. This is a total of 1,280 data points: four aspects of cash flow conditions x 2 size bands (SME and Large Corporate) x 8 regions x 20 quarters.

Figure 4.3: Incidence of late payment experienced by SMEs by region (four-quarter moving median)

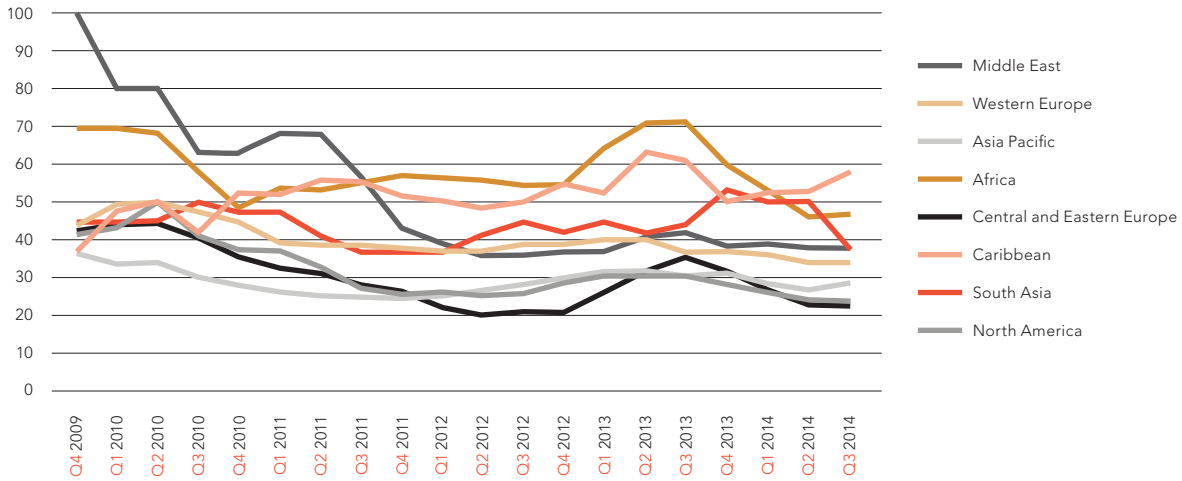
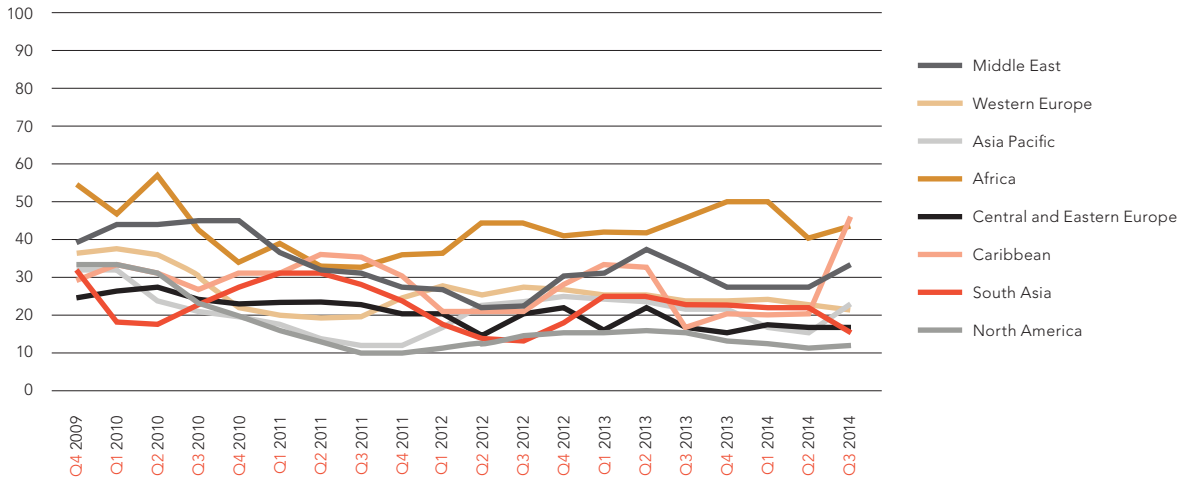


Figure 4.4: Incidence of late payment experienced by corporates by region (four-quarter moving median)



Despite these complications, it is possible to isolate the impact of the business cycle on late payment. In ACCA's regression analysis of GECS data described earlier in this chapter, those respondents who believed that their national economies were deteriorating or stagnating were almost twice as likely to report late payment as those who reported improving or stable conditions (see Figure 4.5). The business cycle effect was itself, however, strongly related to economic development and business size.

In frontier markets, where a lot more business is cash-based and access to both retail and wholesale finance is limited, the trend in late payments lagged behind the broader business cycle, but waves of late payment were more persistent when they did set in (see Figure 4.5). The business cycle effect was also substantially weaker for smaller businesses, which are exposed to relatively poor cash flow conditions through more of the cycle (see Figure 4.6). Fiscal policy influences payment trends, but not uniformly so – other things being equal, micro and small enterprises were more likely to report late payment in countries where the fiscal outlook was uncertain, as more businesses were tempted to hoard cash; this effect was almost certainly stronger in emerging Europe and the Asia-Pacific region.

Figure 4.5: Late payment and the business cycle: comparisons across stages of development

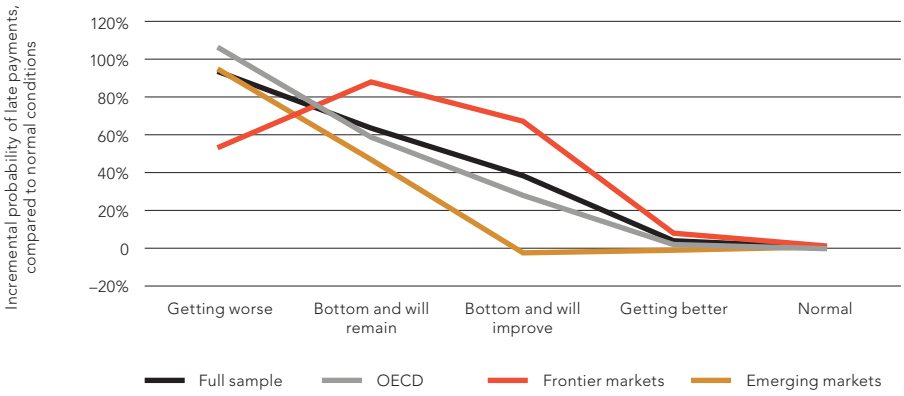
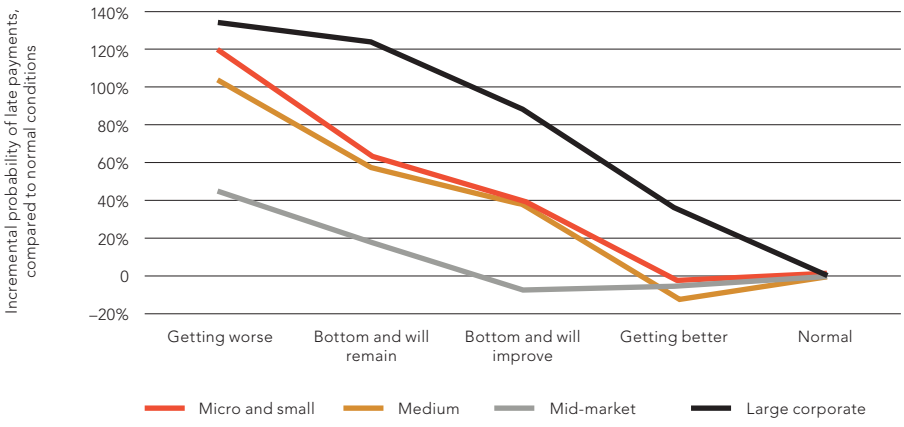


Figure 4.6: Late payment and the business cycle: comparisons across size bands



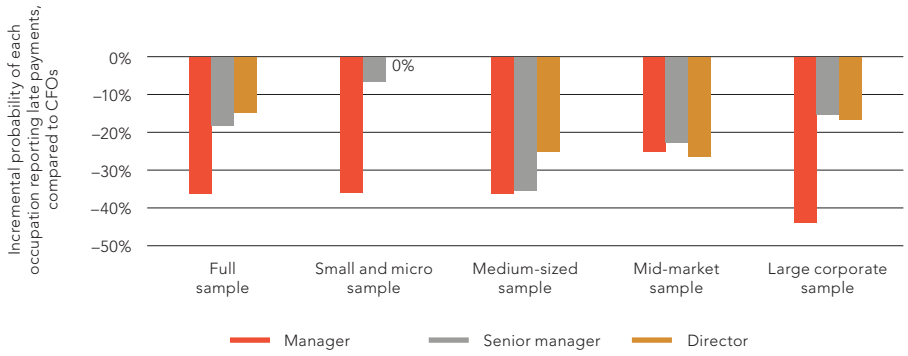
VULNERABILITY TO LATE PAYMENT – TWO SURPRISING RESULTS

The analysis employed in this section yielded two unexpected findings. The first relates to the superior ability of mid-market firms[7] across regions, compared to smaller businesses, to resist the effects of the business cycle on prompt payment (see Figure 4.6). This is particularly true in emerging Europe and the Asia-Pacific region, where the mid-market accounts for most of what is a surprisingly strong record in securing prompt payment. The reason for the mid-market's superior performance is almost certainly that many such firms are extroverted and innovative companies, and are growing fast owing to a unique product or value proposition.

The combination of greater market power and diversified sources of income makes it possible for them to resist late payment in a downturn in a way that only the largest corporates can rival. It is possible (though impossible to prove here) that this competency can also explain some of the superior growth performance and prospects of the mid-market – being cash-rich is an advantage for a growing firm, especially in emerging markets or financial downturns, where it can fuel rapid growth by acquisition.

An equally surprising finding concerns the sheer lack of visibility of late payment across organisations (see Figure 4.7). The regression analysis discussed in this section was calibrated to use chief financial officers (CFOs) as a control group, which makes it possible to compare the likelihood that a CFO will report late payment with the likelihood that a person in any other occupation will do the same. The results of this analysis suggest that the visibility of late payment falls quickly as one becomes further removed from the top finance leadership position, with even directors 15% less likely to report late payment than CFOs. A key exception were directors in small and micro-enterprises, whose involvement in trade credit tends to be direct and immersive, and who were just as well informed as any CFO.

Figure 4.7: The visibility of late payment, by occupation and business size



7. ACCA's analysis of the mid-market refers to businesses with 250 or more employees that are nonetheless described by GECS respondents who work in them as SMEs. For a further discussion of this class of enterprises see ACCA (2014c).

5. The impact of late payment

Even when it is not accompanied by default risk, late payment costs suppliers in multiple ways – higher costs associated with the financing of working capital, forgone interest on cash reserves, administrative costs associated with collections and recoveries, work passed up and substantial distraction for business staff and, often, owner-managers. These costs are often enough to turn paper profits into real losses even for businesses with healthy customers and uninterrupted access to finance – they can create a perverse system whereby small firms, which are typically less creditworthy and efficient, are tasked with the financing and administration of the supply chain.

Uninterrupted access to finance, of course, is the exception, not the rule, in business. ACCA's research suggests that emergency funding can take as long as six months to arrange in developing countries, in the meantime exposing suppliers paid late to serious risks unless directors are willing and able to make up the cash shortfall. For many small suppliers unable to finance their working capital quickly, late payment can be a death sentence; and from a macroeconomic perspective economies pay the price through increased barriers to entry, and thus reduced competition in sectors where late payment is rife.

Research carried out for the European Commission (Connell 2014) suggests that eliminating chronic late payment in three peripheral Eurozone countries (Italy, Spain and Portugal) would reduce business exits as a share of the business population by between 1.5 and 3 percentage points – essentially pre-empting a very substantial share of all business failures. In the three countries studied, this equated to between 124,000 and 248,000 additional enterprises staying in business each year.

No businesses need fail for an economy to feel the adverse effects of late payment. Carbo-Valverde et al. (2013), for instance, use a very large panel dataset of Spanish SMEs to demonstrate that credit-constrained businesses depend on trade credit to finance capital expenditure, and that this dependence grew during the most recent financial crisis and its aftermath.

This means that persistent late payment can potentially depress business investment, especially in times of economic recovery – in turn reducing productivity, real wages, and overall growth. For example, Murfin and Njoroge (forthcoming) show that a one-month delay in payment by an investment-grade customer would tend to reduce suppliers' capital expenditure by 1.2% in normal times and as much as 2.1% in a recession, leading to reduced profitability for as long as five years thereafter.

ACCA's own detailed analysis of GECS data[8] suggests that, for the broad business population, the apparent effect of late payment on business hiring and investment can be mostly explained away as a result of poor access to finance – ie businesses facing late payment also tend to face financing constraints, and it is the latter that most directly reduce investment and employee recruitment. The risk of customer insolvencies is a stronger but still statistically insignificant influence. Nonetheless, even after accounting for all other possible influences, late payment does make a disproportionate difference to certain enterprises' capital expenditure and decisions on recruiting employees.

First, micro and small businesses are less likely to increase numbers of employees or capital expenditure when faced with late payment – the effect of late payment on the likelihood of small businesses' employment and capital expenditure expansion was significantly greater than for large corporations, by 54% and 47% respectively ($p=0.015$ and $p=0.025$).

Second, while the mid-market is generally more resilient to late payment than the rest of the business population, its capacity-building decisions are more sensitive to customers at genuine risk of default. The impact of such customers on new capital expenditure decisions was 43% greater among mid-market firms than among large corporates ($p=0.039$).

Finally, the effect of late payment on capital expenditure and job creation was more muted in emerging markets (Asia Pacific and Central/Eastern Europe) than in developed markets. In emerging markets, plans for job creation were 78% more likely to survive late payment, while capital expenditure cuts were 25% less likely to result from late payment ($p=0.054$ and $p=0.027$).

8. This analysis is based on a series of four binary regression analyses, with the following dependent variables: 1. increase in capital expenditure, 2. decrease in capital expenditure, 3. job creation, 4. job losses. The regressions controlled for business size and class, type of market (developed, emerging or frontier), and stage of the economic cycle, as well as the full range of business challenges and opportunities and investment environment variables included in GECS. The model also controlled for interactions between 1. business size and late payment, 2. type of market and late payment and 3. stage of the business cycle and late payment. The same interactions were tested for access to finance and customers at risk of insolvency.

6. The case for regulation: systemic risk through trade credit

It is important to distinguish between the idiosyncratic and the systemic impacts of late payment. The former, discussed in detail so far, mostly support the case for sound business controls and good practices against late payment. In practice, a case for regulation must be made on the basis of economic externalities – and, as with all financial markets, the chief externality that should concern policymakers is systemic risk.

As a rule, late payment propagates the cash shock from a credit crunch, a high-profile bankruptcy or an economic downturn throughout the economy. Research by Graydon (2012) for the Forum of Private Business found that among UK SMEs the reason most commonly cited (by 77%) for paying suppliers late was late payments further up the supply chain, and that many (41%) reported paying their own suppliers late in response to late payment. Meanwhile research by ACCA and the CBI (2010) found that UK suppliers were quicker than the country's banks to cut credit in response to a downturn. The contagion of otherwise healthy firms is amplified by the behaviour of finance providers, who generally avoid exposure to individual businesses experiencing credit rationing from their suppliers, but can also avoid exposure to sectors or locations known for high or rising default rates (BDRC 2014).

From both a theoretical and empirical perspective, Boissay (2006), Raddatz (2010), Jacobsen and von Schedvin (2012) and Boissay and Gropp (2013) offer robust evidence of the systemic nature of trade credit. Taken together, these studies demonstrate that:

- the more trade credit that business offer, the more vulnerable they are to customer defaults
- businesses that suffer customer defaults are more likely to default themselves
- default risk propagates faster through the supply chain during economic downturns
- over time, the use of trade credit increases the output correlation between supplier and buyer industries, thus increasing the opportunity for contagion
- trade credit contagion will tend to continue until it reaches a supplier with uninterrupted access to external finance.

Only a few estimates exist of the economic loss due to trade credit contagion. Of these, perhaps the most notable is Boissay's calculation (2006) that the US economy may have lost up to 2.3% of its potential output during the 2001 recession from contagion through trade credit. Here it is important to make three observations.

First, the claim that uninterrupted access to finance is the most effective obstacle to trade credit contagion is problematic. Smaller firms' access to finance is itself influenced by their cash positions and trade credit conditions in their sectors, and can thus be eroded quickly in a severe downturn, creating a dangerous feedback loop. Eventually, only a substantial intervention from a third party with a visible stake in the entire supply chain can halt the contagion – the obvious candidate is government, but the financial sector can also play this role. Using a large dataset of inter-firm transactions from Japan, Hazama and Uesugi (2012) found that contagion can be limited if a single institution finances multiple parts of the supply chain. These institutions, which the authors name 'deep pockets,' can help halt the cascade of defaults through timely intervention.

Second, that late payment travels throughout the supply chain in a manner similar to that of defaults. Abdul-Rahman et al. (2010), for instance, demonstrate that late payment is a leading cause of delays in the construction sector, triggering a cascade of further late payments down the supply chain.

Finally, the findings of Boissay and Gropp (2013) on output correlation and trade credit mean that the systemic risk associated with this method of financing will tend to grow during periods of economic growth – even though the incidence of late payment and credit defaults might fall. Moreover, as supply chains can often span countries and continents, with specific regions specialising in a particular range of products and services or stage of production, trade credit contagion can cross borders just as any other financial contagion can. Policymakers testing the impact of policies on trade credit need to be alert to these implications.

Systemic risk in the real economy may not seem as threatening as its financial counterpart, since SMEs and corporates are typically much less leveraged than banks; and this can indeed shield them from (some) systemic effects. This advantage is balanced out, however, by

more expensive and less diversified funding, coupled with a lack of expertise in credit and risk management, especially among small businesses. Banks are protected by the diversity of their business borrowers, while suppliers will tend to be disproportionately exposed to a small number of customers, in a small number of related sectors. Moreover, unlike financial institutions, which are subject to prudential regulation, suppliers are not, and generally cannot be, required to adhere to capital adequacy or liquidity rules. Finally, unlike financial institutions, the real economy has no access to a lender of last resort – in some cases (eg the UK's Business Payment Support Scheme (BPSS) the tax authorities can try to play this role through forbearance, but their contribution is by definition capped at the level of firms' tax liabilities – which, for loss-making businesses in particular, can be quite modest.

The parallels between trade credit and other financial markets suggest that many of the tried and tested tools used to control systemic risk elsewhere can be applied to trade credit as well. 'Systemic' government interventions used during the 2008–9 financial crisis and the subsequent recovery have included:

- accelerated payment of state contractors (ideally with a provision for prompt payment of subcontractors)
- deferral of tax and other payments to government
- state-guaranteed or state-subsidised trade credit insurance
- strengthening and streamlining of insolvency and business resolution
- recapitalisation of major corporates with extensive, specialist supply chains
- state-subsidised supply-chain finance facilities.

More innovative 'systemic' interventions that have yet to be tested could include:

- arrangements for governments or central banks to acting as 'buyers of last resort' for business receivables, in order to ensure uninterrupted access to factoring/invoice discounting options
- options for 'bailing-in' business creditors by allowing them to take an equity stake in a defaulted trade debtor
- mapping of trade credit flows and supply chain vulnerabilities; identification of 'systemically important' businesses
- mandated corporate reporting requirements that focus on exposing reliance on long terms of credit or late payment.

7. Summary and conclusions

The market for trade credit supports almost half of all business-to-business transactions globally. Though often overlooked by policymakers, trade credit is a more important source of short-term funding for SMEs than bank lending, and its importance is growing as businesses become smaller, more services-oriented and less formal.

This is not to say that trade credit can be a long-term substitute for bank lending and other formal finance. It is a form of intermediation whereby, in net terms, businesses with good access to formal finance provide credit and liquidity insurance to more financially constrained ones. This system creates value for the global economy owing to the superior information, control and collateral available to trade creditors and represents a superior lending technology to banking alone. It helps both creditors and their suppliers grow, and makes long, complex supply chains sustainable by giving everyone a stake in the supply chain's collective success. Every business that sells on credit is a financial intermediary, and should think of itself as such.

Nonetheless, not all credit-based transactions proceed smoothly; very often the timing of payments does not match the expectations of both suppliers and buyers, giving rise to late payment. While this may sound straightforward, ACCA has identified 13 types of deviations from prompt payment, each of which calls for a different approach from businesses and policymakers. Failure to distinguish between the many alternatives to payment can lead to poor policies and outcomes.

Late payment hurts individual businesses and the wider economy in a number of ways – from increased costs to reduced capital spending or failure of suppliers' businesses – and its impact is exacerbated among credit-constrained businesses. Unsurprisingly, it is the employment and investment decisions of smaller businesses that are most sensitive to late payment. Since businesses with fewer than 50 employees are typically twice as likely as large corporates to report problems with late payment, the cumulative impact of persistent late payment on small business activity can be very significant. Like other financial markets, trade credit is also vulnerable to systemic risk – late payment and customer defaults can move along the supply chain, crossing industries and borders until they are absorbed by the most financially secure financial institutions, or indeed governments.

Because of its disproportionate impact on the smallest businesses, late payment is often discussed as evidence of the poor corporate citizenship of major companies – but on its own this approach is incomplete and unhelpful. Late payment is 'a feature, not a bug' in the market for trade credit. ACCA's experience suggests that it is very common for SMEs and even large corporates to be paid beyond agreed terms; such late payment often does not involve very long terms of credit, and it very rarely leads to actual customer defaults.

At its heart, late payment is demand for cash, and its appeal stems from the fact that it is cheaper and more accessible than loans. Yet unlike requests for longer terms of credit, payment outside credit terms is usually 'sub-prime' financing, particularly attractive to cash-poor businesses struggling to obtain other finance. From the supplier's point of view, tolerating late payment against the promise of future business is often a rational choice – as is forbearance when a customer is facing difficulties. It is this combination of incentives that makes it so hard for policymakers to tackle late payment; and in economic downturns or less developed markets the case for tolerating late payment becomes stronger.

As a result of its 'sub-prime' nature, late payment is strongly cyclical. In the depths of a recession, the chance that an SME will report late payment more than doubles, while large corporates, which are normally less affected, see an even bigger increase. Only the mid-market stands out for its ability to resist late payment during recessions, as a result of these businesses' greater market power and extraversion. The resulting ability to remain cash-rich during downturns may be central to the mid-market's dynamism, as it can fuel profitable investment and acquisitions.

ACCA's review of the evidence so far warns against simplistic interpretations of, and reactions to, late payment. It demonstrates how important it is for businesses and governments to understand late payment and have the right policies and tools in place for dealing with it. These are examined in detail in the second report of this review, *Ending Late Payment, Part 2: What Works?* The evidence discussed in the present report, however, also

provides a set of objectives for government intervention in the trade credit market:

- to dampen the systemic impact of late payment on the economy, by encouraging 'deep pockets' (eg financial services firms or tax authorities) with a stake in the entire supply chain to take an active role in supporting businesses

- to ensure that the legal and policy frameworks for incorporation, financing, contracts and insolvency are aligned to deal with different aspects of late payment promptly and in a consistent manner

- to encourage trade credit by giving suppliers a minimum level of protection against supplier dilution – ie the reassurance that even when customers fail suppliers can still look forward to a minimum level of recoveries

- to ensure that businesses can look forward to a similar level of discretion in negotiating credit terms with their customers regardless of whether they are new or repeat suppliers

- to encourage the development of financial markets so that businesses have quick access to alternative financing options in response to changing terms of credit or unexpected late payment.

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ENDING LATE PAYMENT

In 2014, ACCA conducted a review of the widespread problem of late payment, a life-threatening challenge for many businesses globally. This review bought together recent ACCA research with the experience of ACCA members and other finance professionals to examine potential solutions.

The outcomes of this review have been presented in three reports.

- *Ending Late Payment, Part 1: Taking Stock* combines an extensive literature review with quantitative data from ACCA's member surveys to correctly define late payment, trace its precise origins and document its impact on the global economy.
- *Ending Late Payment, Part 2: What Works?* brings together a wealth of ACCA-commissioned publications and other secondary research as well as 36 case studies involving ACCA members around the world to help define good practice in business and policy.
- *Ending Late Payment, Part 3: Reflections on the Evidence* summarises ACCA's findings and issues a call to action for governments, financial services firms, large corporates and small businesses.

The three reports are available from

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- ***The State of Business Finance, Part 2: Case Studies***, brings together twelve in-depth studies of business financing seen through the eyes of ACCA members around the world.
- ***The State of Business Finance, Part 3: Reflections on the Evidence***, summarises ACCA's findings and issues a call to action for governments, the financial services industry and, most of all, finance professionals around the world.

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