ACCA

Ending late payment

PART 3: REFLECTIONS ON THE EVIDENCE

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

It summarises ACCA's findings on this important issue and is a call to action for governments, financial services firms, large corporates and small businesses.

ABOUT THE AUTHOR

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Introduction

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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 suggest a correct definition of 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.

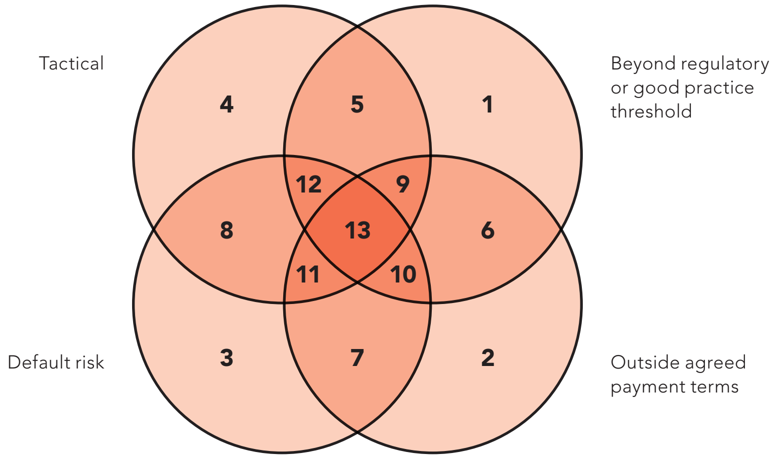
Ending Late Payment, Part 3: Reflections on the Evidence summarises ACCA's findings and issues a call to action for governments, financial services firms, large corporates and small businesses.

1. What is late payment?

Late payment is a common by-product of one of the most important financial markets in the world – the growing market for trade credit, which supports almost half of all business-to-business transactions globally. The term 'late payment' can refer to many different types of behaviour (see Figure 1.1), but the most common form appears to occur when healthy customers simply pay invoices after the agreed date.

At least 30% of all credit-based sales in developed and emerging markets are paid outside the agreed terms, although fewer (between 16% and 21% of all credit-based sales) are paid more than 60 days after the invoice date. Bad debts in trade credit are relatively rare: consistently below 3% of the total. Contrary to what is commonly thought, it is larger businesses with better access to finance that are net creditors to more credit-constrained businesses.

Figure 1: The late payment universe: deviating from prompt payment expectations



Key to Figure 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.

2. Why does late payment happen?

Late payment is not really the product of flawed business or national cultures as is often implied. Industry structures, norms and hierarchies, relative market power, business cycles, financial infrastructure and legal systems are much stronger influences. It is not surprising that smaller businesses suffer the most from late payment, but there is also no straightforward link between business size and late payment.

Late payment in its various forms is essentially a demand for credit. Its appeal to buyers stems from the fact that it is cheaper and more flexible than loans, and its appeal to suppliers is that it provides them with a claim on their customers' future business. Protracted terms of credit are the 'prime' expression of such demand, while payment outside the agreed 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. This combination of incentives makes it very hard for policymakers to tackle late payment; and in economic downturns or less developed markets the case for tolerating late payment becomes stronger. Armed with better information and occasionally more influence over their trading partners, suppliers are actually more effective sub-prime lenders than the banking sector.

In an ideal world, where all solvent businesses would have prompt, uninterrupted access to finance from diverse sources, late payment would be very rare (as the result of surprisingly poor conditions and/or insolvency) and it would present only a manageable risk to businesses. Suppliers would factor it into the cost of doing business and cost-conscious buyers would keep payment as prompt as possible. Regulation would be unnecessary.

This ideal world, of course, is very far removed from the reality of business, especially in emerging markets. Smaller businesses, in particular, face significant financial constraints and arranging a new facility can take between one and six months – making late payment much more than simply a 'cost of doing business'. Around the world, the reach of alternative finance (including invoice finance and trade credit insurance) is growing fast, but is still relatively limited.

3. Why is late payment a problem?

Although late payment can be rational, it is also extremely inefficient from a macroeconomic perspective. It hurts individual businesses and the wider economy through increased costs, reduced hiring and capital spending and the failure of suppliers. Its impact on the weakest businesses is particularly acute: those with fewer than 50 employees are typically twice as likely as large corporates to report problems with late payment, and the impact on this business segment can be seen clearly in subdued job creation and investment.

Like other financial markets, the market for trade credit is also likely to give rise to systemic risk. 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. 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.

4. What is the late payment 'end game'?

'Ending late payment' is a worthy ambition shared by many governments, stakeholders and individual businesses around the world. Unfortunately, the problem of late payment has long resisted a simple definition, and a solution has remained elusive for all but a handful of countries.

Many debates about late payment are premised on the idea that it is the length of terms of credit that primarily needs to be addressed – that if all sales could be settled in a maximum of 30 or 60 days the battle would be won. This is a mistake. Protracted terms of credit are embedded in the function of industries around the world. Trade credit is profitable, on average, for both suppliers and buyers, and helps bind complex supply chains together. Even genuinely late payment has its uses, helping some businesses survive tough economic times, even though it is clearly an inefficient safeguard from a macroeconomic perspective. Crucially though, most instances of late payment worldwide do not involve very protracted payment times (eg over 60 days) – in most cases banning these will do very little to improve outcomes for suppliers.

As one of the early supporters of integrated reporting, ACCA believes that the sustainability of payment terms is best understood in the context of managing relationship capital – with both buyers and suppliers understanding how supply chain relationships create value and investing in them.

In practice, for terms of credit to be sustainable a number of conditions need to be met.

- Buyers' and suppliers' standard terms of credit should be transparent.
- Cash flows to suppliers should be predictable through explicit credit policies and contract terms.
- Invoicing, collections, accounts payable and invoice dispute processes should be efficient and transparent, with senior staff taking responsibility.
- The status of invoices should be easily monitored throughout their lifetime.
- Suppliers should be aware of the cost of providing credit to customers.
- Differentiated pricing should reflect the suppliers' cost of capital, so that neither they nor their prompt-paying customers are forced to subsidise late payers in the long term.
- Customers and suppliers should give each other adequate notice before seeking new terms of credit, so that alternative financing can be sought in time.
- Suppliers should be seek to understand, and customers should be honest about, the causes of late payment and the viability of late-paying customers.
- Payment plans should be set out explicitly in contract terms and genuinely troubled customers should opt for these rather than resorting to late payment.

Many of these conditions are included in prompt payment codes and other similar standards across jurisdictions. ACCA has consistently supported such codes, even though the evidence on their effectiveness is mixed, because it is important that all parties know what 'good' looks like. Nonetheless, such codes are not sufficient on their own. Crucially, countries where late payment has been contained successfully stand out because the aggressive management of accounts payable tends to be unprofitable for customers. This is the outcome of, not the prerequisite for, good practices.

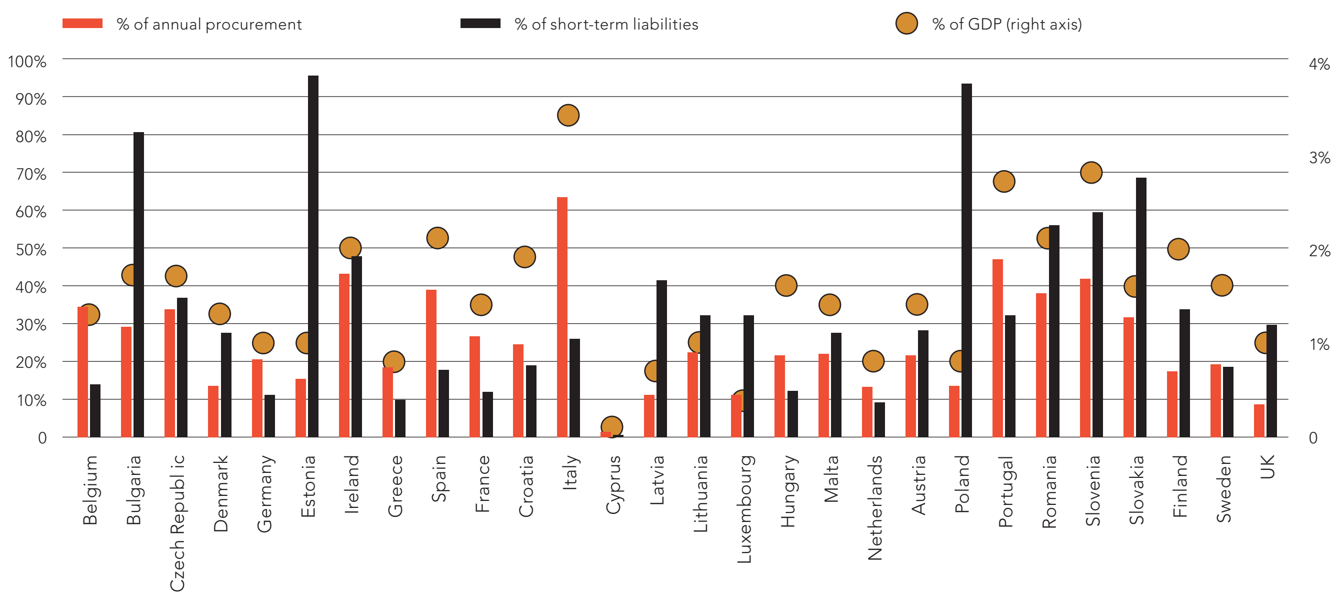
5. Are governments and blue chips different?

There are some exceptional buyers for whom the fight against late payment really ought to come down to shortening the terms of credit. These are buyers for whom access to finance is so easy that they have literally no excuse for demanding protracted credit terms – and thus drawing on businesses for credit.

Any government able to issue investment-grade debt in a liquid bond market, and any agency financed by such a government, is likely to be a privileged buyer in this sense. A business with similar access to the capital markets and a substantial cash balance would also be in this position. Suppliers should not be forced to finance budget deficits or corporate acquisition war-chests. Yet, as Figure 2 demonstrates, governments use substantial amounts of trade credit, even when they are able to borrow at historically low interest rates.

Many governments realise this already and are aiming to pay promptly, harmonise payment terms throughout their supply chains, and pressure blue-chip listed firms to adopt prompt payment codes. They are still a minority, however, and others ought to adopt this policy.

Figure 2: EU governments' reliance on trade creditors (trade creditors outstanding 2013)



6. What can suppliers do?

Suppliers themselves are not as helpless against late payment as some might think, but a highly focused approach is needed to protect a small business. This involves investing in customer relationships as well as in an independent, well-resourced credit control function (either within the finance function or as a stand-alone unit) that works closely with the finance, operations and sales functions, as well as with the customers themselves. Objectives and behaviours need to be aligned across all these parties, with credit policies providing a particularly useful coordination tool.

Suppliers can protect themselves through careful due diligence and in-depth receivables analyses building on ageing debtors reports. They can make more realistic provisions for bad debt, informed by first-hand information gathering, and incorporate these into regular cash projections. There is also a lot that they can do to improve the administration of receivables, from better understanding of customers' systems and the use of automation to bringing in outside expertise on credit control and collections.

For suppliers, the fight against late payments continues with contract design: businesses should ensure that their terms of credit are clear and explicit and that contracts give them appropriate rights over goods that remain unpaid for, as well as the right to withhold services or delivery as appropriate. Even the methods of payment can make a significant difference and must be specified in advance. Finally, despite receiving very unfavourable press coverage, prompt payment discounts can be an acceptable means of aligning prices with the cost of servicing individual customers – as long as they are not imposed unilaterally and at short notice.

Financing and liquidity insurance is a major element of the fight against late payment, and small suppliers in particular need to replicate, as far as possible, the protection provided by the internal cash pools of diversified business groups. Exploring and securing alternative sources of finance (including factoring and trade credit insurance) is important, but ultimately directors must be alive to the implications of providing credit to major suppliers and be willing to take on some risk through equity injections.

Finally, suppliers need to be able to distinguish quickly between late payment and genuine credit risk. There is often no substitute for first-hand inspection and probing. When customers are struggling but ultimately viable, forbearance can work. Businesses should seek to shield themselves from further cash disruption and reduce services to struggling customers but should also use payment plans to maximise recoveries and help customers surmount their problems.

7. What should buyers do?

Buyers, and their boards in particular, have an obligation to have 'due regard' to the need to foster sustainable relationships with their suppliers. In the interest of their own sustainability, rather than just good corporate citizenship, they should take stock of the risks and costs to which late payment exposes them – including continuity costs, loss of access to the best suppliers, and the risk of creating a heavily consolidated supply chain in the long run. They need to monitor the financial health of their supply chains and in so doing extend their focus beyond their largest or most volatile suppliers.

Buyers stand to gain from prompt payment because most of the adjustments they need to make are about systems, not policies – key priorities are improving the efficiency and continuity of accounts-payable management, embracing supplier relationship management systems and e-invoicing. All these interventions are profitable for buyers and suppliers alike: indeed in countries such as Finland, where late payment is in retreat, the link between profitability and late payment appears to have been successfully broken: without weakening the business case for late payment, change will be difficult.

Major buyers should sign up to sector-wide prompt-payment codes where available, and boards, as opposed to public affairs teams and CSR departments, should take high-level ownership of their commitments and report on the treatment of suppliers as an indication of the company's continued viability. Self-regulation is far from perfect but it can help establish expected standards of behaviour, create new industry norms, and prompt innovation among signatories.

Finally, buyers in genuine difficulty need to be open with suppliers and seek credit in a more appropriate manner. ACCA's research shows that a request for additional credit is approximately as likely to be successful as an intentional attempt at late payment – and that suppliers can be very reasonable when dealing with honest partners.

8. Regulating trade credit and the role of government

All governments try to regulate trade credit in one way or another; there is no lack of awareness of the problem of late payment or of political incentives to take action against it. What is, however, often lacking in the politically and emotionally charged debate on late payment is clarity over what activity is being regulated, and why.

Policymakers need to be clear on whether they are regulating credit, which can be a useful and efficient policy, or effectively regulating differential pricing through credit, which is almost always counter-productive. Where suppliers have a free and straightforward choice about whether to extend credit or provide discounts, and can account for the cost of working capital through their prices, credit is simply another input and thus does not need to be regulated. The primary purpose of good trade credit regulation should be to restore this choice to suppliers that have previously lacked it. Restricting practices such as early payment discounts or even the controversial 'pay to play' agreements used by some buyers need to be considered only in this context, or otherwise not at all.

Policymakers need to ensure that their efforts target the systemic risks associated with trade credit as well as the risks to individual businesses. Late payment and defaults can, for instance, be prevented from spreading by protecting unsecured debts incurred by failing businesses immediately prior to administration. Governments can also influence the banking sector and credit insurers to commit to a set of good practices in dealing with businesses or sectors suffering a cash flow interruption, so that they do not propagate late payment by unnecessarily withdrawing facilities. Even more decisive will be the influence of 'deep pockets'- banks that supply credit to multiple players in a supply chain (perhaps through reverse factoring facilities whereby approved invoices are bought from suppliers at a small discount) can mediate potentially problematic credit relationships, and the tax authorities can act as a creditor of last resort to troubled businesses.

Policymakers ought to focus more of their efforts on improving the behavioural aspects of trade credit, eg by demanding that contractors cascade good credit terms down the supply chain, or by improving the bargaining power of suppliers through 'capacity events: regular contract allocation and renewal periods during which contractors are likely to pay more promptly in order to keep sub-contractors on side and ensure ongoing capacity.'. The easiest way to do the latter is to ensure that government contracts are renewed relatively frequently, forcing customers to rely more on the goodwill of subcontractors.

Finally, policymakers have to understand that many of their efforts are effectively regulating insolvency as opposed to trade credit. Most regulation that relies on suppliers to initiate legal action against customers is likely to make a difference only when customer–supplier relationships are beyond repair or when customers fail.

To be sure, policymakers can greatly improve access to trade credit and discourage late payment by improving the efficiency of the courts, and by providing arbitration and alternative redress options for businesses. These are all important objectives, but for trade credit regulation to be more widely effective, the onus cannot be solely on suppliers to report and police late payment. Business associations must be empowered to take on this role, both legally and financially where possible. The wholesale adoption of e-invoicing and supplier relationship management (SRM) systems can also make a substantial difference in this regard, by making invoicing and payments more transparent. It is no coincidence that the countries that have most enthusiastically adopted e-invoicing can boast some of the lowest rates of late payment in the world.

In addition to their responsibilities for the legal infrastructure, governments have an obligation to help build a financial infrastructure that will mitigate late payment and boost trade credit. This can involve support for movable asset registries and credit bureaux, or the sharing of credit information, and extend to support for alternative finance sources and trade credit insurance – a market which governments, led by China, have entered very dynamically since the financial crisis. Governments can also boost the supply of information through mandatory payment-terms reporting for companies, and should consider the best way to provide investors with actionable information.

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The three reports are available from

www.accaglobal.com/small-business

THE STATE OF BUSINESS FINANCE

ACCA's 2014 review of the state of business finance is an ambitious global investigation into the challenges faced by businesses when trying to raise finance and the ways in which finance professionals in industry, practice and financial services help them along the way.

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

- *The State of Business Finance, Part 1: Facts and Figures*, presents an analysis of two sets of quantitative data taken from the ACCA–IMA Global Economic Conditions Survey.
- *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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