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%.

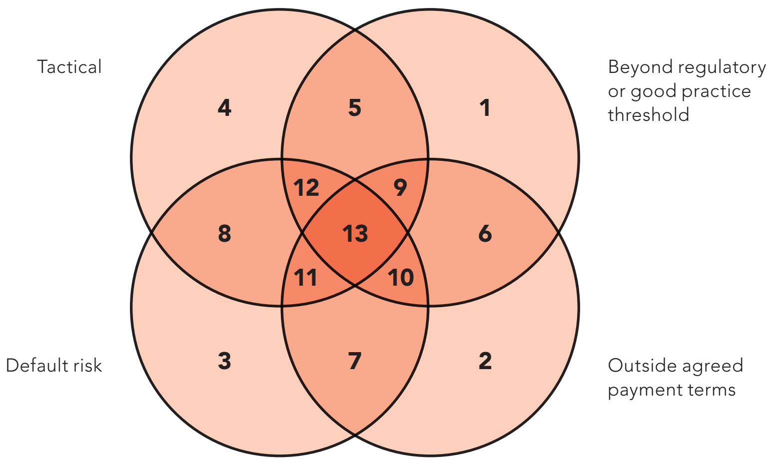
2. Defining late payment

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

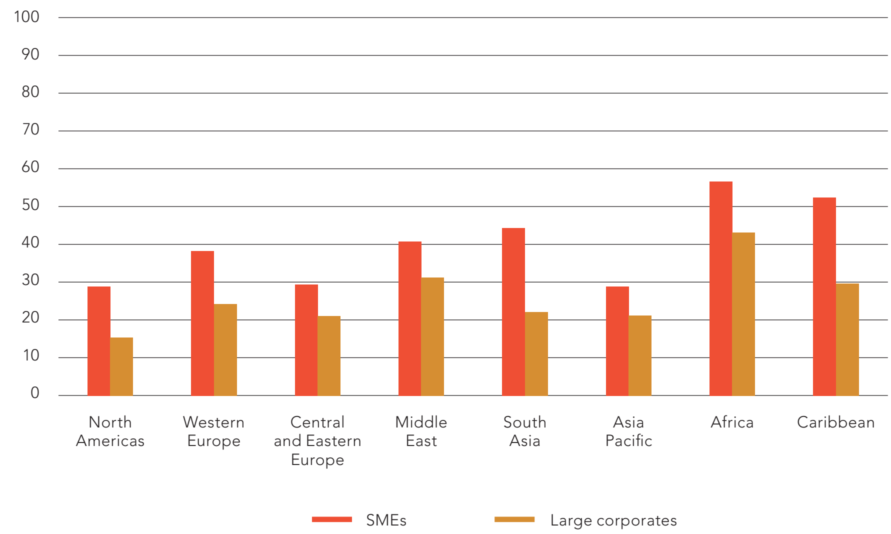
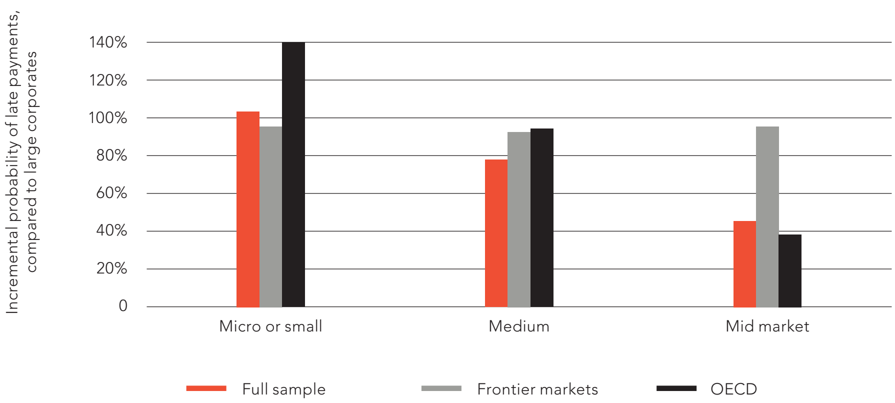


Figure 4.2: Late payment, business size and economic development



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)

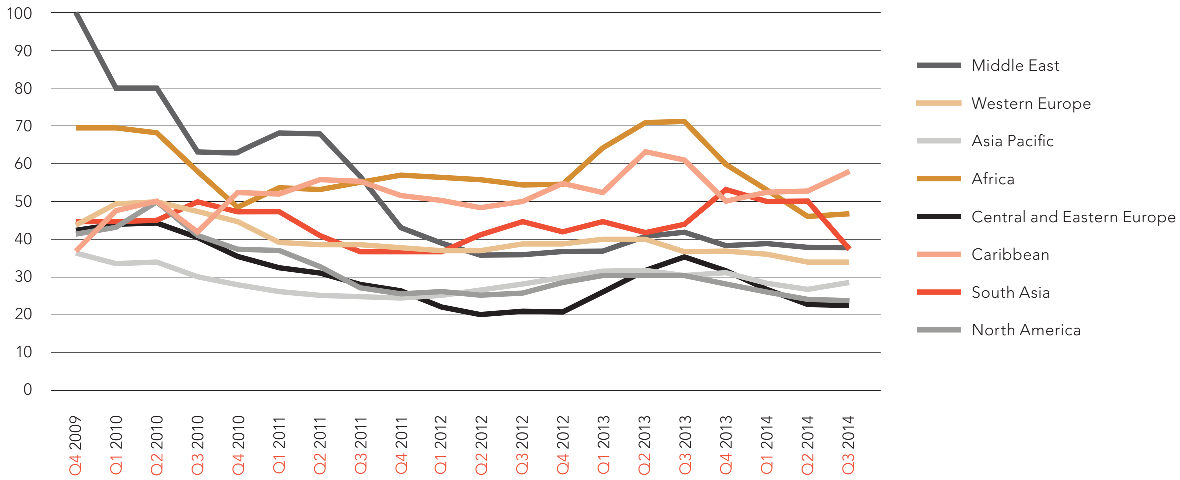
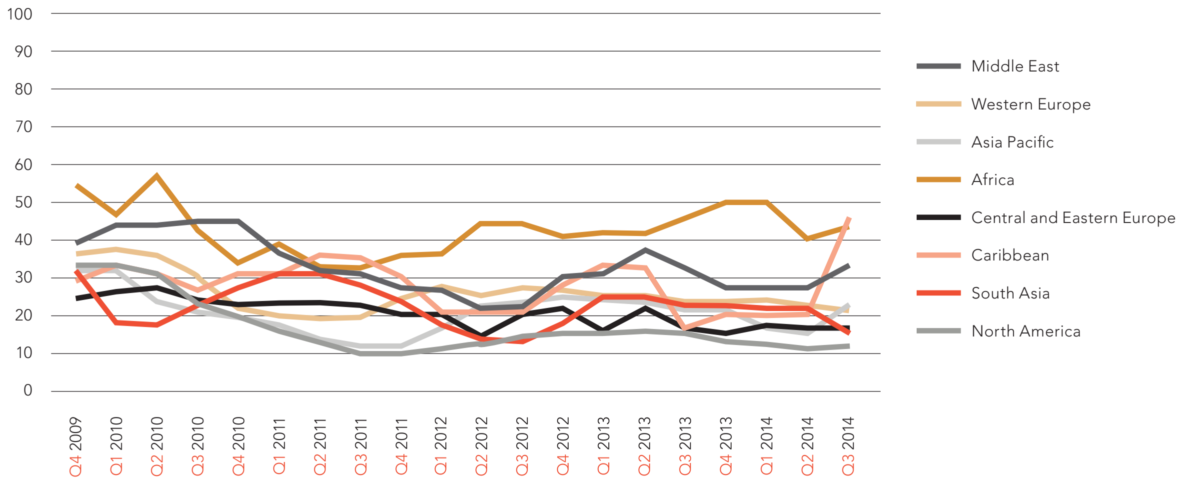


Figure 4.4: Incidence of late payment experienced by corporates by region (four-quarter moving median)



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

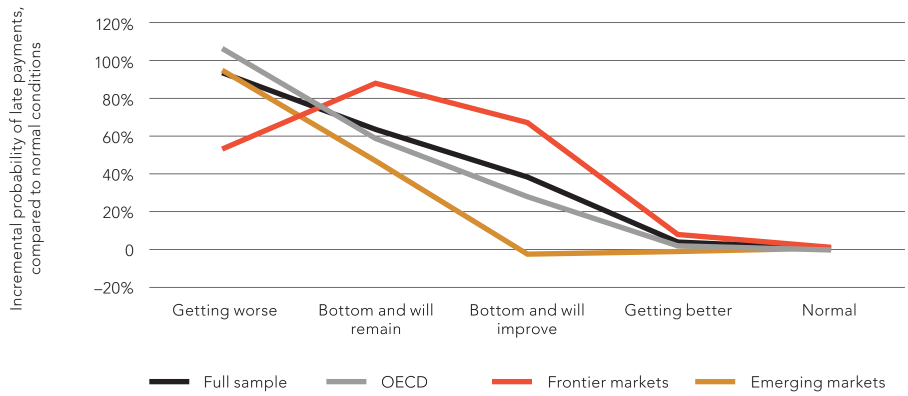
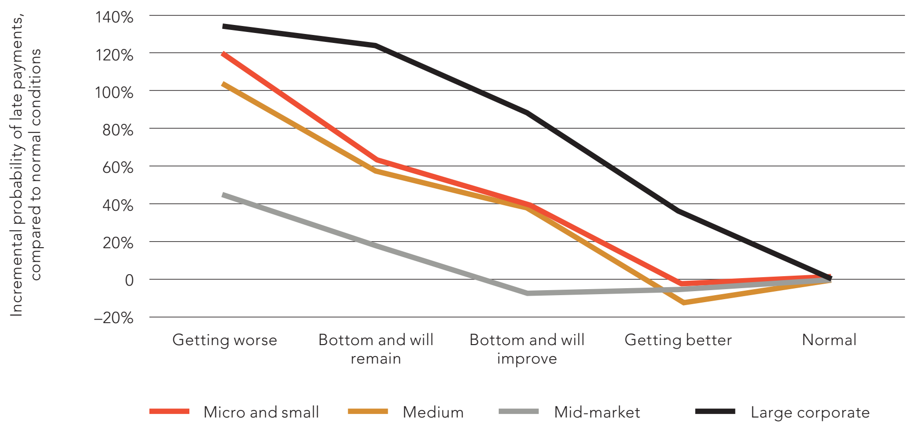


Figure 4.6: Late payment and the business cycle: comparisons across size bands



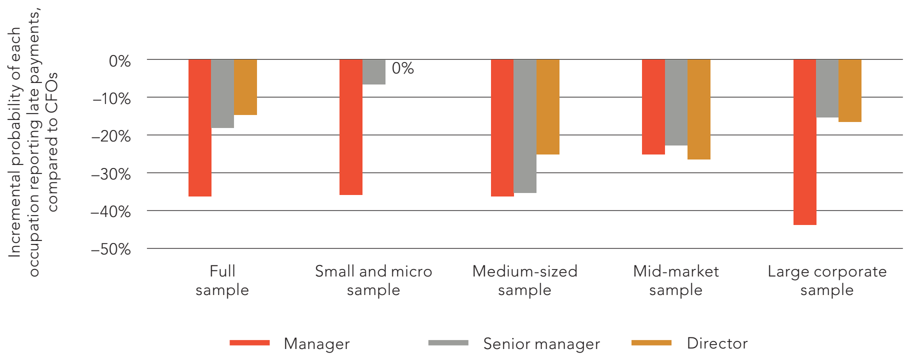
VULNERABILITY TO LATE PAYMENT – TWO SURPRISING RESULTS

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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ACCA

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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Ending late payment

PART 2: WHAT WORKS?

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

It brings together evidence from 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 both business and policy.

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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.

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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 the survival of 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 aim is to help pinpoint good practices in business and policy that can aid in the fight against late payment. It brings together a wealth of ACCA-commissioned publications and other research for this purpose; but at its heart is a selection of case studies involving ACCA members around the world.

In December 2014, ACCA invited around 300 members to share their experiences of dealing with threats from, and to, the rest of the supply chain. As the member sample was drawn from the ACCA–IMA Global Economic Conditions Survey (GECS; waves Q4 2011 to Q3 2014), it was possible for questions to be tailored to three distinct audiences. The exercise distinguished between businesses struggling with late payment despite the viability of their customers, businesses at risk of customer defaults (and late payments), and healthy businesses that nonetheless had suppliers or customers at risk. After selecting for relevance, this exercise yielded 36 usable responses – and the key themes emerging from these are discussed and placed in their proper context in this section.

1. What influences payment terms?

Most members who offered their views for this study generally approached the question of late payment as a function of the position of customer and supplier in industry structures and pay hierarchies. A strong distinction was made repeatedly between paymasters, who can usually control the timing of their own payments, and contractors, who have much less discretion and tend to pass on late payment down the supply chain. Since major supply chains can be many levels deep, most businesses will not tend to be paymasters, or indeed have customers who are. Some businesses nevertheless made a point of finding a niche as high in the hierarchy as possible in order to ensure more predictable cash flows. Others accepted their lot and focused on avoiding defaults and financing their working capital.

Paymasters do not necessarily pay promptly, of course; in fact, they can be some of the worst offenders. They can, however, usually be assumed to present a small or negligible credit risk, making alternative financing (such as invoice discounting) possible. Related to such payment hierarchies was the matter of customers' government ties or public sector status – in most emerging markets, members spoke in no uncertain terms of the political as well as economic power of major buyers, with the extractive industries being singled out repeatedly. Government itself is a paymaster, and in many countries it is the most notorious late payer of all.

Related to such hierarchies was the strong influence of industry norms – long-established patterns of payment terms (and breaches thereof) tied to cycles of demand and commissioning in each industry. Members mentioned industry norms regularly as a starting point for all credit negotiations, and ACCA's research elsewhere (eg Paul and Boden 2012) confirms that they are a key determinant of the relative power of suppliers.

Some industries, especially those with long supply chains, provided an opportunity for reciprocal relationships, whereby the suppliers to one business were also its customers further down the line, or where a key customer would call on trusted suppliers and subcontractors for support when bidding for new business. Reciprocity gives suppliers a number of tools in the fight against late payment – for instance, more than one respondent mentioned that by doing their best to match payment terms on orders outstanding on both sides, they could ensure that the cost of extending credit terms more or less netted off, and keep overall leverage low. Others said that their companies tolerated late payment in exchange for access to future tenders as subcontractors – effectively taking a quasi-equity stake in their customers.

'By the very nature of our business we have to have a degree of flexibility in our payment terms. The majority of our customer base is made up of multinational oil majors – they cannot be pressured into paying, and often have 'in-built' processes that are fundamentally to delay their acceptance of an invoice. It is…a kind of incestuous market where many customers are also suppliers – and vice versa. Because of this there is probability of potential set-off which minimises debt exposure.'

CFO, OFFSHORE SUPPLY VESSELS OPERATOR, CONGO

In a further generalisation of the reciprocity principle, many members were keen to explain that capacity-related norms in their industries created opportunities for collections. Customers keen to manage their capacity ahead of peak times (eg a major holiday or industry event, or a major tendering round) were always more likely to offer prompt payment or settle overdue payments in order to keep suppliers 'on side'.

'We have had key suppliers failing to supply us with materials and goods for lack of prompt payment; in such cases we usually prioritise their payments and clear any outstanding old accounts to enable them resume doing business with us. During the festive season, we usually buy in bulk to enable us to continue operating until the mid-January, when many businesses resume from their breaks.'

ACCOUNTANT, FACILITIES SERVICES COMPANY, KENYA

A hierarchy of customers and corresponding credit terms is commonly maintained by businesses, with new customers offered goods and services on a cash basis only (for as long as six months in some cases), then allocated a credit limit subject to performance, which could quickly revert to zero, sending them back to a cash-basis arrangement. In emerging markets, bank guarantees are commonly required and the pool of eligible banks might even be restricted to a few major institutions. In industries where suppliers can look forward to ongoing project-based business, key suppliers may demand rolling cash advances, calculated as a given percentage of open purchase orders.

Members responding from a buyer's perspective noted that there were also hierarchies of suppliers, based on monopoly power and their ability to disrupt the purchaser's output. Not surprisingly, powerful suppliers tended to demand better credit terms or even upfront payment, and were rarely paid late. Exceptionally, suppliers of goods with substantial transport costs could also expect the same treatment. It is likely that monopoly power can explain much of the mid-market's success in ensuring prompt payment – as discussed in Part 1 of the Ending Late Payment series.

> 'There are certain products of ours whose features are much better than the competitors', for which we will ask for 100% settlement before goods are shipped. In other words, we do this when no real substitute products exist. Having said this, most of our products have competition. So, we do what most competitors do: we have an internal credit control department, which is independent from the business / operation team. They are authorised to go after the customer when needed. Apart from this, we have worked with the banks to factor receivables at a preferential rate. We include such cost into our margins model before we sell or commit to our customer about the price.'

CFO, INDUSTRIAL AUTOMATION COMPANY, CHINA

Overall, respondents stressed the importance of relationships in gauging the financial strength of both customers and suppliers, and noted that long-standing relationships, aided by industry expertise, can often be much more informative than formal controls – though ideally the two should complement each other.

These views are in agreement with past ACCA research. Using a quantitative approach, ACCA and CBI (2010) found that, of all the formal and informal methods used by SMEs in dealing with late payments, only relationship management had a significant impact on the quality of SMEs' receivables. The importance of relationships in providing information critical to credit decisions as well as a lever by which to achieve prompt payment is confirmed by Paul and Boden (2012) for the UK and by Collis et al. (2013) across different countries.

Relationships contribute greatly to credit control, but members also noted that supplier relationships can suffer from discontinuity due to staff turnover, succession or change of management, a merger or acquisition, or some other rare and disruptive event on either side of the transaction. In such cases, important knowledge and ownership of suppliers relationships are often lost and it is possible for credit controls and indeed the quality of receivables to deteriorate as a result.

Finally, members did not always see a clear distinction between late payment due to administrative failures and tactical late payment (ACCA 2015). In fact, some explained that customers have 'built in' processes to delay acceptance of an invoice, whether through overzealous queries and disputes or through purposefully convoluted and opaque accounts-payable procedures.

2. Dealing with customers in trouble

Members were clear that late payment is often a signal of genuine and/or permanent credit risk and distinguishing this from tactical and administrative late payment was a very high priority in their credit practices. Such a distinction must be made early because internal policies and external enforcement options differ enormously under the two different scenarios.

'To use a German expression, you cannot delve into the pockets of a naked man.'

HEAD OF ACCOUNTING AND FINANCE, FACILITIES SERVICES COMPANY, GERMANY

Members reported that direct contact, including on-site visits or access to on-site staff can help businesses make a quick judgement and ensure that they are well prepared; a failing customer will generally find it hard to disguise its condition. Other red flags mentioned included reduced orders, surprise requests for discounts, and changes of company names or premises.

Most members argued that credit risks are potentially reversible if addressed early, and most (though not all) focused on preserving or cementing valued commercial relationships. Research evidence confirms the value of this approach. Even during the worst of the Global Financial Crisis of 2008–9, Finley (2009) shows that businesses displaying tell-tale signs of distress had at least a full financial quarter before they experienced a crisis. With genuine but reversible credit risks, treatment of customers in trouble was dependent on the attitude and transparency of the customer, and could often include cheaper and more substantial forbearance than could be achieved through late payment: extending terms by three months was common.

The most common approach to forbearance was to prioritise protecting the supplier's own cash flow from further disruption, by agreeing on the orderly receipt of future payments, sometimes even at a small discount. A payment plan could then be agreed for the outstanding debt, with customers generally unable to access the supplier's full range of services (eg warranties) during this period.

'When a customer has been identified as having trouble our first step is to protect ourselves. We look at what is outstanding but also what contracts may still be open and running. As long as our customers are honest with us in relation to their situation we try to work with them to correct the situation. There is no point in behaving aggressively where the company may just be having a short-term difficulty which, although problematic, can be solved with cooperation. The experience of credit control staff with individual customers is crucial because over time they develop a gut feeling, if you will, as to when something is not in order.'

HEAD OF ACCOUNTING AND FINANCE, FACILITIES SERVICES COMPANY, GERMANY

'We ring-fence the old debt and come up with a plan that sees all current invoices being paid regularly while arrears are paid systematically until they are cleared. This has helped customers to keep afloat during times of financial difficulty and allowed customers to revise their business models.'

FINANCIAL CONTROLLER, AUTOMOTIVE INDUSTRY, ZIMBABWE

Members' experiences of such payment plans were generally positive and they emerged as a useful tool. Nonetheless, as the viability of customers became more doubtful, it was clear that most members quickly ceased to expect significant recoveries through conventional means: only a going concern can secure that. Crucially, forbearance needs to be a tailored plan, not a blanket policy: ACCA and CBI (2010) show that simply making allowances for difficult economic times tends to reduce the quality of UK SMEs' receivables, all other things being equal.

3. Policies and structures

Input from ACCA members suggests that much of the challenge in credit control comes from the misalignment of incentives within the business. The incentives of sales teams are usually tied to contracts won, profit margins and sales figures, while those of finance or credit control functions (where these exist) are tied to recoveries and cash flows. As a rule, it is tempting for businesses to empower revenue generators at the expense of those in charge of credit control, but most businesses tried to establish a balance. In their research for ACCA, Paul and Boden (2012) show that this tension is everywhere – from large corporates to husband-and-wife management teams splitting the sales and collection roles between them. Their research also found that successful small businesses had managed to turn credit management into an enabler, not a gatekeeper, by allowing the business to reward prompt payers and choose appropriate terms of credit for others.

In their own evidence, ACCA members recommended that the business should emphasise communication between Sales, Finance (or AR/Credit Control) and Operations, ensuring that all three are clear about their responsibilities, which should in all three cases include collections. For example, one member explained that in their company collections were discussed in client meetings, with finance or credit colleagues present. Another explained that it was crucial that both sales and credit control understood the internal processes of clients, and had opportunities to develop relationships with them. Monthly credit control meetings focusing on key debtors, with all three functions involved, were cited as a useful means of coordination.

'The predicament the organisation is experiencing today is due to lack of communication between the finance team (in particular the Accounts Receivable team) and the operations team. The area of responsibility is vague and the operation team assumes 'collections; is exclusively a finance team's function. …Despite regular discussions, business area teams tend to give more leniency to the customers with the overriding objectives of securing jobs, and hence revenues. Business area teams tend not to discuss collection or debts when meeting their customers. The situation is exacerbated, in my opinion, as the primary KPIs for the business area teams exclusively focused on revenue and gross margins, and to a lesser degree EBITDA [earnings before interest, taxation, depreciation and amortisation]. Their bonuses are exclusively dependent on these KPIs.'

DIVISIONAL FINANCE DIRECTOR, OIL AND GAS SECTOR, MALAYSIA

One final area where collaboration was seen as particularly important was dealing with disputed invoices. Collections were optimised when the efforts of finance (including short-term extensions of credit terms) could be combined with on-site visits, offers of technical assistance and/or replacements.

In turn, members were at their most content when key performance indicators (KPIs) for sales were tied to cash flows – commission clawbacks were occasionally used as a means of enforcing this. Most significantly, members with good quality receivables stressed the importance of maintaining an independent credit control function with resources proportionate to the funds at stake.

Shared incentives and cross-functional collaboration are important means of aligning behaviour, but even more important is the role of credit policies. Members believed that appropriate policies were crucial and they should be reviewed regularly in light of results, and should require authorisation at appropriate levels within the organisation. A comprehensive credit policy should cover a broad range of topics, from how to determine correct credit limits for customers to how the business should manage collections, conduct debt provisioning and decide on debt write-offs, as well the correct level of authorisation required for agreeing extraordinary terms with a customer. Paul and Boden's findings (2012) confirm the importance of credit policies, and explain that these do not need to be overly complex to be effective – in fact the opposite is usually true. Policies need to be communicated across Sales, Operations and Finance, and indeed to the customers themselves. Finally, when policies are out of date or prove unrealistic, it is better to modify them decisively than let them become disused, as that will encourage staff to make ad hoc decisions.

'In the last six to seven years when financial problems became acute for many companies we empowered the credit control department by transferring personnel with specific skills from other departments of the [finance function]. Also, we improved our internal procedures by establishing credit control meetings every month to which participants are the sales director, the credit control manager and, as a minimum, two executive members from the board of directors.… We tried to help customers facing financial difficulties by changing their credit terms. The most common way was by agreeing with them to pay cash for new deliveries and for the old balance to be repaid in one or two years. Of course changing credit terms also resulted in a change in pricing.'

CHIEF ACCOUNTING OFFICER, FOOD PROCESSING COMPANY, GREECE

A number of members also said that their companies carried out comprehensive due diligence on customers before raising or removing their credit limits. While 'due diligence' is a very broad term, the most commonly cited elements involved commissioning background checks on directors, buying annual credit reports from third parties and using databases of media mentions and court decisions. Many suppliers implicitly or explicitly blacklist late-paying customers, and well-connected businesspeople will routinely have informal access to this information as well. Due diligence might be moderately expensive, but it was seen as a good investment when preparing to deal with large companies or government buyers – since the supplier would have little leverage on its customers and it would be difficult for the firm to extricate itself from these relationships.

'In my sector, most coal mines are controlled by state-owned companies, and thus hold big bargaining power when deciding the business contracts; any post-contract receivable control policies would be useless. So it is only prudent for us to carry out investigations into these clients beforehand. Normally we ask questions of these companies' current suppliers, such as whether there are any late payments outstanding, and the frequency with which these occur. As for other, smaller clients, we insist on a payment in advance policy because the geographic locations of coal mines in our country are scattered and it would be financially impossible to take any useful follow-up actions when late payments happens.'

FINANCE DIRECTOR, COAL MINE INSTRUMENTS COMPANY, CHINA

Finally, prompt payment discounts were contentious when demanded unilaterally and with little notice, creating what Paul and Boden (2012) call 'effective late payment', but generally speaking they were often seen by members as a useful tool for suppliers. If planned carefully, they need not represent a discount at all from the supplier's point of view, but rather a cross-subsidy from late payers to prompt payers that effectively corrects for differences in the cost of working capital.

4. Dealing with uncertainty

Cash flow management and forecasting are essential disciplines for businesses, for the purposes of both financial management and raising finance. Yet late payments can complicate forecasts by introducing an element of uncertainty over which management has little control.

Making informed cash projections usually starts with ageing debtors' reports; these can break down each customer's outstanding balance into groups of invoices according to the amount of time elapsed since the customer was invoiced, allowing management to rank customers according to risk and in each case apply different assumptions about the likelihood of prompt payment and recoveries. Ageing reports are usually communicated to sales and operations teams, and are also used to distinguish between the merely late and the doubtful; here the assumptions used may vary dramatically. Businesses applying a conservative definition will flag up payments overdue by as little as 30 days as doubtful, but in countries where late payment is endemic, 180 or even 360 days would be used as the cut-off point.

Occasionally, some suppliers would use ageing debtors' reports not in order to forecast inflows but to engage in duration-matching – essentially ensuring that accounts payable were delayed enough to offset the impact of late payment. This common practice can be helpful to individual businesses, but it is likely that it also helps exacerbate the systemic effects of late payment.

A reasonably resourced finance or credit-management team will generally prepare a receivables analysis and an analysis of customers' payment histories on a regular basis, though typically high-value customers will receive the most regular treatment – for instance, one member explained that their company prepared monthly reports on all customers but weekly ones on major customers.

Such analyses can then inform bad debt provisions and cash flow estimates, the frequency and depth of which varies according to resources and need. Cash flow forecasts themselves are typically weekly, are updated on a regular basis, and can look one or two years ahead, hence bad and late debt forecasts are applied against these. Estimates of overdue payments are prepared less frequently, typically on a monthly basis and as part of the management accounting process, and forecasters use these to adjust future cash inflows downwards, in order to allow for bad debt. In members' evidence, this 'haircut' would be determined based on individual customers' histories, the credit manager's experience of past defaults, feedback from colleagues involved in collections, but most of all from information gleaned through direct and regular contact.

'By definition, theoretical collection plans will not work in South Asian countries…Very few companies are paymasters and the majority of SMEs' funding is from the lead and lag of payments. Therefore projections are prepared based on historical records and on industry knowledge such as the seasons of the industry. For example, in the media industry credit periods extend up to 90 or 120 days, but during seasons such as the New Year in April and Christmas in December, customers may pay in advance in full for reservation of your slots. Bill discounting only started in Sri Lanka a few years back, but it is with recourse and there is no absolute assurance of recovery.'

HEAD OF GROUP FINANCE, MEDIA COMPANY, SRI LANKA

Since late payment is ultimately at the customer's discretion, it is important not to overstate how predictable it is. 'Rules of thumb' are used widely. One respondent, for instance, explained that their forecasts always began by assuming that 20% of receivables would be paid late. Another assumed that 3% of receivables would eventually have to be written off – both not too far off from the regional averages reviewed by Atradius (2014). Whatever the rule of thumb used, the estimate can subsequently be revised on the basis of actual information; the benefit of this treatment is that it creates a useful conservative bias and places the onus on finance to confirm that payments are indeed likely to be received. External information can also be used to inform rules of thumb. One member explained that the trend in non-performing loans (NPL) in the financial sector was used along with the firm's actual rates of late payment in the previous year in order to develop assumptions about overdue payments.

Where resources were scarce or customers were atypical, purely ad hoc provisions based on direct, informal knowledge, were not unheard-of either; these need not be inferior to any other method, but do require regular monitoring and updating. To ensure adequate feedback, and regardless of how late payments and bad debt were forecast, businesses checked the robustness of credit policies by defining a level of 'tolerable' variance from cash projections, which would trigger a review of policies.

5. Core business practices and late payment

Most members believed that all-important business relationships should not be left to chance, but, rather, treated as major operational priority. Members spoke of involving multiple directors to maximise the social collateral behind the relationship, and ensuring monthly meetings, not including social occasions, to cement the personal touch as well as gather up-to-date information on customers. This is a labour-intensive and time-consuming approach, which at least one member admitted was hard to justify when working with smaller customers – hence their preference for larger businesses.

Credit terms are, in the end, contract terms and thus contract design is a first line of defence against late payment. At the most basic level, members stressed the need for clarity of wording, eg the terms of credit themselves or the precise dates from which credit terms apply. Members recommended adding clauses entitling the supplier to invoice for penalty fees or statutory interest automatically in the event of late payment, and language ensuring that the supplier can hold lien on goods sold and retain ownership of them until they are paid in full; this should give the supplier the legal right to reclaim unsold stock in the event of late payment. As a rule, suppliers should also reserve the right to withhold delivery of new orders or warranty on old orders until they have been paid in full. Especially in the case of international transactions, the actual modes of payment should be specified in writing, favouring methods such as letters of credit and bank guarantees, as opposed to bank acceptance drafts, which one member explained incur higher costs when discounting or holding to maturity.

Despite all these options, late payment was still a fact of life for many businesses. One way to deal with it was by managing exposure to individual clients and sectors. This could involve diversifying the firm's income across customers and product lines, or choosing to do business only with major paymasters or with large, stable companies.

Efficient administration is an important tool in the cause of avoiding late payment. Members insisted on the value of not only understanding the customer's systems, invoicing in the correct format, and knowing the individuals in charge of payments, but also invoicing and communicating demands early, accurately and at predictable intervals – starting ahead of the date when payment was due and increasing in frequency. Many members argued that 'staying on top' of projects and customers in this way increased their chances of prompt payment, and some reviewed their billing processes annually to ensure that appropriate pressure was being applied.

One respondent noted that accounting software allowed scheduling and automation of many invoicing- and collections-related tasks, removing any excuses for poor management – an attitude that the accountancy profession should arguably champion. Using collections agencies was also seen as a convenient ways of professionalising collections, although Paul and Boden (2012) warn that businesses should be careful to maintain ownership to the actual commercial relationships at all times.

Finally, the use of supplier relationship management (SRM) systems was cited both by suppliers and customers as an important tool in preventing late payment and alerting customers to suppliers potentially put at risk by their credit policies. Supplier relationship management (SRM) systems, especially when they involve electronic invoicing facilities, can provide greater visibility of the status of invoices and remove at least some of the incidence of administrative errors that slow down payments. Academic research also points to the potential for supply chain coordination to limit defaults and late payment. Simulations by Xu et al. (2010), for instance, show that information sharing and vendor-managed inventory systems can reduce systemic risk in the supply chain, but require some element of cross-subsidy since market participants will not always have a direct incentive to invest in them.

'Normally, the main focus in our contracts is the payment terms and credit period, which in most cases is 45 to 60 days. However, to avoid any cash flow issues we always opt for the one-month advance equivalent to PO value for any particular month. This not only gives me strong foundations to start any project but increases my confidence in the customer as well. Our customers have also introduced an online SRM payment system, which generates timely POs and E-Invoices to facilitate payments on time. In dire situations, I can go to the board and request a shareholders' loan.'

GENERAL MANAGER FINANCE CNL, TELECOMS COMPANY, PAKISTAN

6. Doing right by suppliers

Although late payment makes headlines, many buyers positively strive to pay promptly, using it to secure preferential access to good suppliers and keep their supply chains healthy and competitive.

'We aim to pay suppliers and subcontractors promptly at all times as we feel it gives us a competitive edge when competing for supplier/subcontractor resource over larger competitors who can offer larger contracts but are known to pay late. We're generally a cash-rich business and continuity and reliability of supply is far more important to us than holding onto cash. This enables suppliers in financial difficulty to tender for work with us safe in the knowledge that they can rely on payment.'

GROUP FINANCE MANAGER, RESIDENTIAL PROPERTY DEVELOPER, UK

Just as suppliers claimed that they would be able to tell when customers had difficulties, most respondents stressed that they would be able to understand when their suppliers are in trouble, using regular contact opportunities to raise red flags. Not all agreed, however, and research confirms that this is not always the case. Finley (2008), for instance, warns that major buyers will tend to concern themselves most about their largest suppliers, particularly their total spend, those with the most volatile prices, those causing the most problems, or simply those that the individual procurement professionals understand best.

'If a key supplier were facing difficulties we would know by word of mouth or by the supplier being unable to meet its obligations and wanting to be paid before the due dates or demanding cash payments…also if the company starts changing their names and business premises without a good reason we will be concerned with that and investigate. We […] always try not to rely too much on one key supplier so that our operations are not affected by them failing to supply us. We are always looking out to get alternative supplier who can supply us with materials and goods of the same quality and more importantly at lower prices.'

ACCOUNTANT, FACILITIES SERVICES COMPANY, KENYA

'We would not normally know if a supplier was having financial difficulties unless they advised us of the same. However, we always have different suppliers form different countries to ensure that we do not face any difficulties in case we have problems with any one supplier. We have at least 3–4 suppliers for the same item to ensure trouble-free operations. We haven't had any such problems with a supplier but we have had one of our customers going out of business because he was not paid by the main contractors. We ended up losing money as a consequence. Normally, we provide for such eventualities as a general policy.'

GROUP FINANCIAL ADVISER, DIVERSIFIED GROUP, SAUDI ARABIA

Members were quick to identify risks associated with supplier failures, which involved delays and cost increases as well as compromises in quality, and one could even point to the fallout from a supplier failure caused by late payment further up the supply chain.

Nonetheless, while most suppliers prioritise protecting themselves from defaults, most customers prioritise continuity of supply. The result is that businesses, especially larger or better-resourced ones, will have multiple suppliers that they evaluate and keep on stand-by; this way of protecting supply has the unfortunate side effect of further reducing the bargaining power of suppliers, potentially feeding the dynamics of late payment.

7. Cash pools, directors and alternative finance

According to the ACCA members interviewed for this review, larger suppliers with group structures and well-resourced finance functions have a key advantage over SMEs in preparing for and dealing with late payments, as their treasury management teams (or regional sub-teams, in very large firms) are tasked with preparing strategies for covering defaults and other short-term working capital requirements. Most importantly, different parts of the business can tap into a shared cash pool, or at least borrow from it at a cost. This support is not given lightly – one member explained that only wholly-owned subsidiaries could tap into the group's cash – but as long as the group's income is sufficiently diversified, such a strategy offers a great deal of protection. Because of this facility, some of the larger businesses responding to ACCA's call for evidence reported that their finance functions do not treat late payments as a cash flow issue at all, but rather one related to profit and loss.

In smaller businesses, this is not an option; finance providers must provide the same safety net, with less certainty and at a higher price. When in plentiful supply, financing and insurance options can provide this safety net, swapping the cost of late payment for the more predictable costs of financing working capital. Many members giving evidence reported having short-term borrowing facilities on standby and reviewing them regularly to ensure that they would be well able to accommodate a substantial late payment or default. Other members explained that directors' loans offered a similar safety net – but the onus would then be on directors to diversify their own income and the pressure on the finance function to anticipate late payment and bad debts would be greater.

8. Neutralising late payment

In the short term, late payment is a fact of life for many individual businesses with limited bargaining power and resources. For many of these, especially when their customers are not default risks, it makes sense to swap the risks associated with late payment for higher operating costs or a higher cost of capital: making late payment a cost of doing business. As a rule, this is possible by improving the transparency of receivables, raising finance against them, insuring them, or some combination of these three. About 8% of ACCA's global membership is involved in securing finance for businesses in this way – about a quarter of all members involved in raising finance at all (ACCA 2014b).

The global trade credit insurance market generated about $10.6bn in premiums in 2013 (Swiss Re 2014), with emerging Asian markets driving all the industry's rise in penetration (premiums to GDP) over the 10 years to 2013 and most of its growth – at an extremely high annual growth rate of 38%, compared with 7.6% globally. This market is notoriously concentrated, with three private insurers (the firms Euler Hermes, Atradius and Coface) accounting for 56% of all premiums globally in 2013. A fourth, the Chinese-government-owned Sinosure, accounted for another 22% through its near monopoly of the Chinese market.

Overall, the insurance industry dampened the impact of the 2008–9 financial crisis only marginally. Faced with a doubling in the value of claims year-on-year in 2008, insurers reduced cover drastically or withdrew it altogether. Trade credit limits fell by 18%, against a 23% drop in actual trade, while state-owned credit insurers' share of short-term credit limits jumped from 15% pre-crisis to 28% in 2010 (Swiss Re 2014). Since then, however, the industry has rebounded and become more flexible, more often offering non-cancellable credit limits or insurance of individual buyers (or groups of such, as opposed to a firm's entire order book). New major sources of information on trade credit risk, such as the ICC Trade Register (ICC 2014), are likely to spur further growth and innovation and help new providers enter the market.

Meanwhile, with volumes of over €2.2trillion in 2013 and growth of around 13% a year between 2009 and 2013, the global factoring market is both mature and fast-growing (ICC 2014a). Growth is being driven primarily by cross-border financing, which has, since 2009, grown twice as fast as domestic factoring, and by the growing entry of commercial banks into the sector. Unlike credit insurers, factors saw a once-in-a-lifetime opportunity in the recovery from the financial crisis of 2008–9, with global volumes growing by 57% between 2009 and 2011 as bank lending retreated and banks shifted from unsecured lending and overdrafts to invoice discounting and factoring. Europe dominates the global factoring market with 60% of advances, with Asia a distant second at 27%.

Yet factoring and invoice discounting in particular can carry a stigma in many industries as the mark of a failing business, while many buyers, including in the public sector, strongly object to having their invoices used in this manner – and many around the world place bans on assignment of their invoices. Appropriately, the UK government was consulting, as of late 2014, on making such bans null and void in private sector business-to-business contracts in the UK (BIS 2014b), having only removed such requirements from its own contracts in 2008.

Supply chain finance is a much younger industry, and is growing much faster, particularly in Europe and the largest emerging markets (Demica 2012). The ACCA Global Forum for SMEs (2014) predicted growth of at least 20%–30% a year for the industry in its recent review of financial innovation, while research commissioned by ACCA (Camerinelli 2014) found a potential $255bn to $280bn saving available through reverse factoring. While buyers would stand to benefit most, capturing about 35% to 50% of these savings, another 25% to 45% could accrue to suppliers as the difference between discounts offered and financing costs avoided. Significant examples of supply chain finance initiatives highlighted by the Global Forum for SMEs (2014) included Mexico's Cadenas Productivas, backed by the state development bank Nafin, or the Global Trade Suppliers Finance (GTSF) programme supported by the International Finance Corporation (IFC). A key uncertainty holding back the growth of the industry is the accounting treatment of receivables under supply chain finance – particularly whether they should be treated as the buyer's debt to the financial institution involved (Sodhi and Dalla 2012).

Anecdotally, it appears that the growth of both factoring/invoice discounting and reverse factoring has been driven substantially by the pressure on banks from rising capital requirements, and the pressure on supply chains from a lack of financing for smaller suppliers. Sensing a rare growth opportunity, many banks may have entered the market without necessarily having the expertise necessary for this (Quinn 2009).

That said, when implemented correctly, such options provide more than a safety net to suppliers. Among the ACCA members who provided case study material, users of trade credit insurance and factoring often saw as much value in the additional expert credit management resource included in these services as in the insurance or financing themselves. Raising finance through insured receivables can yield even greater results, at a price. Despite high levels of user satisfaction, access to such services could be limited in developing countries, and might require collateral or other concessions, or otherwise be prohibitively expensive.

One key technology that could act as an important enabler of supply chain finance is also growing fast, keeping pace with the growth of supply chain finance itself. E-invoicing globally is growing at around 20% a year, and as of 2013 it accounted for over 8% of all business-to-business and business-to-government invoicing worldwide – about $170bn (Koch 2014).

By making the status and progress of invoices transparent to suppliers, finance providers and buyers at once, e-invoicing can remove a great deal of the uncertainty and administrative errors surrounding payments, thus helping avoid some kinds of late payment and improving suppliers' access to finance. In Europe, prompt payment ranks highly (third of nine) among industry motivations for embracing this technology (ACCA 2012) and unsurprisingly, many of the countries leading the fight against late payment, such as Denmark and Finland, are also frontrunners in the adoption of e-invoicing. Furthermore, ACCA's research among UK SMEs (ACCA 2014a) suggests that small suppliers using e-invoicing have a much better chance of securing alternative finance (usually invoice discounting) when offered adverse terms on overdraft facilities by their banks.

9. Legislating against late payment

States around the world try to regulate trade credit – both in the fundamental sense of enforcing contracts through the judicial system and in the sense of imposing maximum credit terms, especially in contracts between government and businesses, or giving suppliers the right to claim compensation from late-paying customers.

The 2011 EU Late Payment Directive, which was transposed into national law in the EU member states between 2012 and 2013, is perhaps the most widely applied regulation of this kind, but many countries have similar legislation in place. Very often, late payment laws apply specifically to government agencies or to particular sectors involving complex supply chains – specifically construction – with a view to protecting subcontractors as well as prime contractors. Late payment laws specific to such sectors are actually more common than blanket late payment legislation, and can be found, eg in the US, Australia, New Zealand, Ireland and Malaysia. As of early 2015, efforts were also underway to pass similar prompt payment legislation across Canada, starting with Ontario.

As a rule, late payment regulations can give suppliers and sub-contractors a range of tools against late payment. These may include:

- a cap on the credit terms that can be agreed explicitly or implicitly in a contract, or on the terms that can be agreed without further justification
- a right to statutory interest on overdue payments, charged at a penalty rate
- a right to compensation for costs incurred in chasing and collecting late payments
- access to dispute-resolution mechanisms
- an obligation on prime government contractors to respect agreed credit terms regardless of the timing of payments by the buyer
- an obligation on prime government contractors to pass on the terms of credit agreed with end-buyers and/or to notify the buyer of any prompt payment discounts received
- a right for government subcontractors not paid on time to appeal to the end-buyer for payment, which may then be deducted from any payments due to the prime contractor
- a right to withhold further services until payment is received
- the voiding of bans on assignment in contracts.

Evidence of success achieved through such regulation, however, is still sparse. Reviews of the EU Late Payment Directive of 2000 (Hoche 2006) and the UK Late Payment of Commercial Debts Act of 1998 (Wilson 2008) found very small increases in prompt payment following the introduction of regulation, despite a period of brisk economic growth and unprecedented access to finance. Hoche (2006) suggested that a change in attitudes might be the most significant impact, with fewer businesses agreeing that late payment is 'part of our [country's] culture'.

ACCA's own figures from the Global Economic Conditions Survey (GECS) allow for a more nuanced analysis of the impact of the 2011 Directive. Although its implementation was followed by a reduction in the incidence of late payment to SMEs throughout Europe, this has almost always been the result of improvements in access to finance and the reduction in the rate of corporate insolvencies (Figures 9.1 and 9.2). Nor does the new Directive seem to have brought payment trends for SMEs closer in line to those for large corporates – if anything the GECS data suggest the two have diverged (Figure 9.3).

Figure 9.1: Percentage of SMEs in Western Europe reporting cash flow challenges

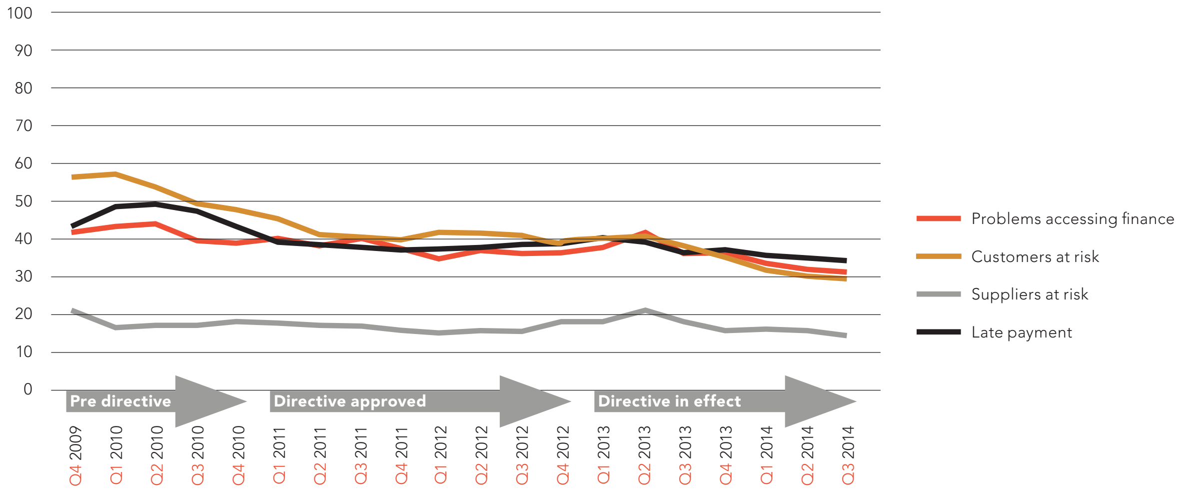


Figure 9.2: Percentage of SMEs in Central and Eastern Europe reporting cash flow challenges

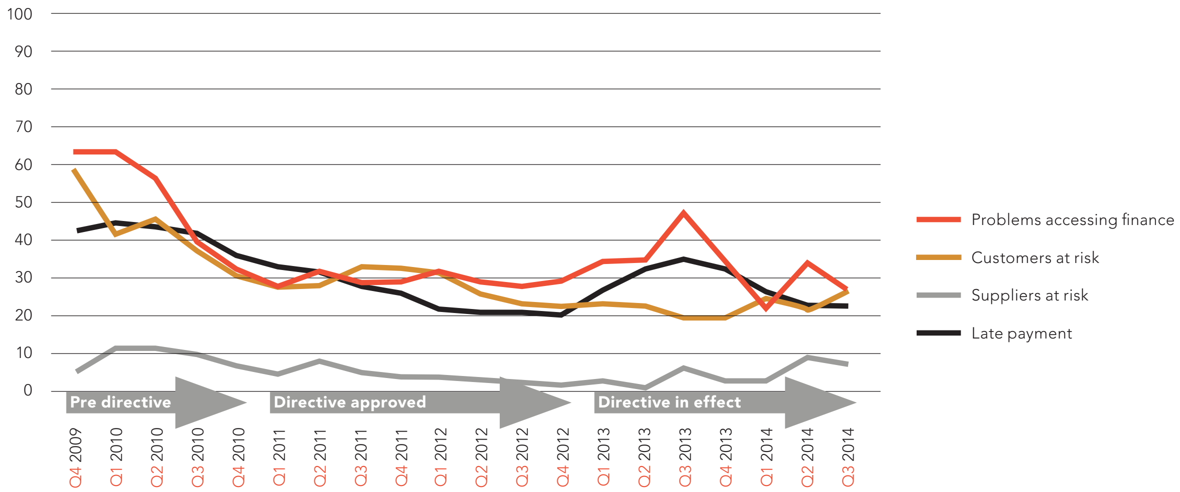
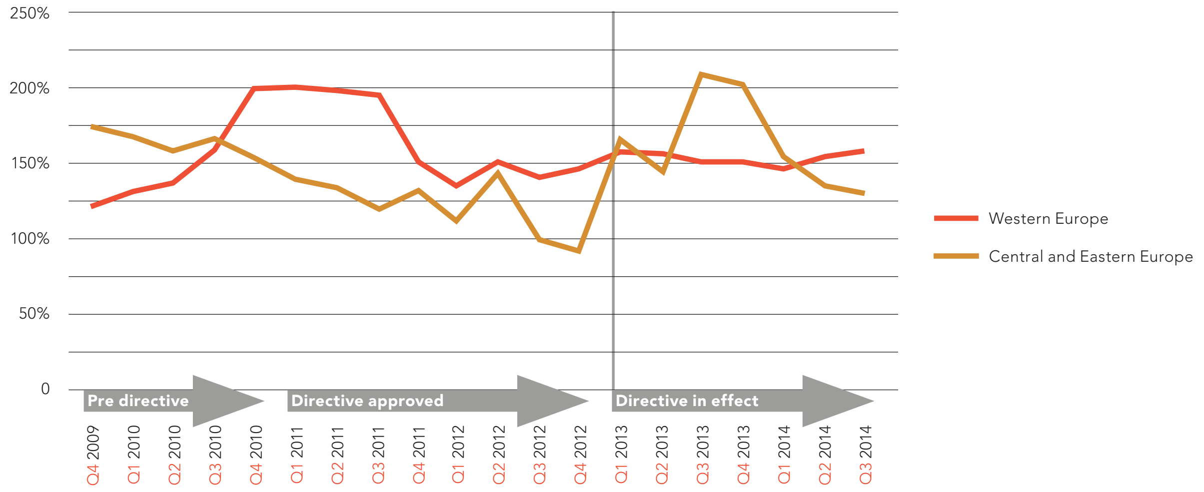


Figure 9.3: How much more likely than large corporates are SMEs to report late payment, post-Directive?



Self-regulation is also used in many countries to complement firms' rights under the law. ACCA has long supported, for instance, the UK Prompt Payment Code, administered by the Chartered Institute of Credit Management (CICM) since 2008. The UK code has provided inspiration for prompt or responsible payment codes in South Africa (since 2013), and in Ireland and Italy (since 2014), but with some variation signatories to all four tend to commit to:

- paying within agreed terms
- refraining from retrospective changes to terms
- avoiding changing terms on unreasonable grounds
- providing clear and accessible guidance on payment procedures
- providing and communicating a dispute-resolution system
- giving prompt notice of problems likely to delay payment of an invoice
- cascading good practice throughout the supply chain.

It is not clear how much influence such codes have on behaviour. In the UK, stakeholders have generally supported the code but warned that a lack of enforcement and accountability of signatories as well as a lack of transparency on outcomes can severely weaken its application (BIS 2014a). The lack of proposed limits to credit terms will also tend to revive controversy about such Codes (ACCA 2014). The South African Prompt Payment Code specifies a limit for credit terms (30 days) and even one for dispute resolution, whereas the UK government was consulting on including a similar cap in the UK Prompt Payment Code as of late 2014.

On one level, ACCA, supports codes regardless of their immediate impact on payment terms, on the basis that what constitutes good practice must be made explicit to suppliers and buyers alike. Awareness of such codes can build a shared understanding about what regulatory tools can then also be created, and may provide a valuable signalling device for good buyers. ACCA also believes that codes can be strengthened further; for example, stakeholders' input to BIS (2014a) suggests that a range of measures could complement or enhance a prompt payment code:

- a confidential 'whistle-blowing' process
- a record of successful challenges of payment terms
- a register of payments complaints
- an audit scheme for code signatories
- appointment of named 'owners' of the code within signatories
- transparency requirements, including the publication of standard contracts.

A QUALITATIVE STANDARD FOR LATE PAYMENT: 'GROSSLY UNFAIR TERMS'

Since what represents 'acceptable terms of credit' is a complex matter, regulators have occasionally sought to appeal to a qualitative standard for unacceptably long terms. The EU Late Payment Directive of 2011 requires that terms should not exceed 60 days unless explicitly agreed between the two parties and provided the terms are not 'grossly unfair' to the suppliers.

Under the Directive, 'grossly unfair' terms can be struck out of a contract by a court, but the onus remains on the supplier, or a representative business body, to make a legal challenge to such terms. For the time being, this option provides little protection to suppliers – there was, as of 2014, almost no legal precedent in Europe to help suppliers establish whether they had a case, and the costs involved in such legal action were certain to be substantial (BIS 2014a).

The Directive does not explicitly define 'grossly unfair' terms, except in the case of contracts requiring suppliers to waive their rights to compensation under the Directive, which guarantees that such terms will qualify as 'grossly unfair'. The term 'grossly unfair' hinges on the civil law concept of 'good faith', which does not directly translate outside civil law systems but is generally understood to indicate the opposite of opportunistic behaviour (Mackaay 2011). The Directive stresses that all circumstances of the contract must be considered in determining whether terms are grossly unfair, and merely outlines some factors that should be considered. These include, in particular:

(a) whether the terms represent a gross deviation from good commercial practice and are contrary to good faith and fair dealing,

(b) the nature of the goods or services in question, and

(c) whether the purchaser has any objective reason to deviate from the 60-day limit for payment terms. (European Commission 2011)

The UK government consulted recently (BIS 2014a) on stakeholders' understanding of 'grossly unfair' terms, and almost a quarter of responses indicated that a single, economy-wide definition would be impossible. ACCA's response noted that other contract terms, such as where buyers reserve the right to amend terms unilaterally at short notice, or make payment contingent on factors unobservable to or outside the control of the supplier, might also constitute 'grossly unfair' terms.

10. The limits of the law

As a rule, the ACCA members who contributed to this study opined that invoking legislation was not a very promising approach for businesses struggling against late payment. Although threats of litigation, involving both overdue payments and legal costs, were sometimes used as a behavioural nudge, overall, legal action itself was very rare and almost always reserved as a last resort when the relationship with a customer had broken down irreversibly or when the customer was failing.

Clearly, it is difficult to place the onus of triggering a legal challenge on the supplier; members generally argued that customer relationships would be damaged by such actions, which would cost them more money in lost business than they could possibly recoup through prompt payment. The law might offer even fewer options in emerging market settings where debtors are politically influential or government owned – adding political and social implications to the already daunting commercial ones; one member remarked that only a 'truly desperate' firm would take this course.

When it comes to failing customers, members and their companies insisted that they always reserved the right to use all legal means available to them, but noted numerous shortcomings that made the process unappealing. The most common complaint was that the process takes too long to secure any meaningful recoveries and can be excessively complex and expensive for all parties. Administrator and legal fees in particular, could cancel out many of the recoveries in a liquidation. In the best of cases, a first hearing in court might take a month; in the worst, two to three years; either way, the full cash flow implications of late payment would be experienced by the supplier.

These claims are borne out by the World Bank's Doing Business publications (World Bank 2014), which review, among other things, the ease of enforcing contracts and resolving insolvent businesses around the world. As Table 10.1 illustrates, suppliers in key South Asian emerging markets, such as India, Pakistan, Bangladesh or Sri Lanka, have to wait around or over 1,000 days in order to enforce contracts – and only in a few countries can businesses enforce contracts in less than a year; resolving insolvencies takes even longer. Among major ACCA markets, Singapore stands out for the speed of contract enforcement, and Asia-Pacific generally performs well – perhaps explaining some of the region's success in avoiding late payment (ACCA 2015).

Once again, in discussing the options provided by regulations and the law, members drew a clear distinction between late payment by failing customers, and tactical or administrative late payment. Because the law is easiest to invoke in the event that a customer fails, it is particularly unfortunate that legal systems throughout the world provide suppliers with limited protection from creditor dilution – essentially, secured and preferential creditors (including employees) have a legal advantage, whereas a wide range of unsecured creditors, including trade creditors, have to make do with whatever assets are left.

Another, more easily-overlooked shortcoming of the legal approach is caused by the fact that businesses can disguise removable assets – through transfers to business directors and their families or other businesses within a group. One ACCA member remarked that small debtors may be even harder to pursue through the courts than large corporates as it is easier for them to conceal business assets. Movable asset registries provide one answer to this problem, and have been found to improve access to both formal and informal credit significantly (Love et al. 2013).

Strict enforcement does not always make a difference either, if there is no focus on tactical late payment and tactical default. For instance, while one ACCA member in Malawi regretted the fact that issuing cheques that subsequently 'bounced' was not criminalised in Malawi, in Sudan defaulting on cheques is a criminal offence and can lead to a prison term. Another member noted that this has resulted in incarcerations but without proportionate recoveries.

'In our country legislation has made defaulting on cheques when they come due a criminal offence and the debtor can be brought to jail till he settles his outstanding debts, but I don't think this is making any difference to the process of late payment. We end up watching many traders being sent to jail without any money being repaid.'

CHIEF INTERNAL AUDITOR, SUGAR COMPANY, SUDAN

Of course, the fact that businesses might despair of the legal system is no argument for governments to abandon the idea of redress altogether – it is, rather, a call for reform. 'Justice delayed is justice denied', and ACCA members pointed out that such delays can positively encourage late payment. Moreover, governments certainly have been known to make a difference; there is evidence from ACCA members that different legal structures have different implications for the feasibility of claiming late payments. For instance, one member noted how the merger of their country's Arbitrary and Civil-Criminal courts had increased the court backlog and exacerbated the problem. A member in another country noted that the introduction of small claims courts promised some relief from late payment. Arbitration can also often provide a solution; one member, in particular, noted that even with adequate legal protection in place, most cases are settled out of court to avoid mutual embarrassment.

These findings suggest that, regardless of the intentions of lawmakers, regulatory safeguards against late payment are more likely to be used as behavioural nudges or as means of boosting collections against insolvent parties. This needs to be carefully factored into the design of regulation, with more attention dedicated to supporting suppliers in relationships that they wish to maintain.

That said, respondents also provided examples of circumstances under which court decisions can, in themselves, make a difference:

- if they can act quickly to ring-fence the bank balances of the customers on behalf of creditors, before the troubled customers' suppliers withdraw and the business begins to fail, creating a widening cash flow interruption

- if cases taken to court have an immediate impact on customers' credit scores; the downside, of course, is that this creates a disincentive for businesses to report late payments at all, unless reporting can somehow be automated

- if the courts can approve the use of bailiffs in order to facilitate recoveries; whenever the topic was discussed, members reported significant success and suggested that seeking to use bailiffs was a time-honoured company policy.

Concessions to the first of these rules can be seen in the use of freezing injunctions or the European Account Preservation Order in the EU, which allow the freezing of debtors' accounts under certain conditions, including the posting of collateral by creditors. Such measures have, however, been criticised for jeopardising the continuity of businesses in financial difficulty, and essentially allowing the courts to decide on the viability of a business (R3 2014). A better balance is struck in the US, where any outstanding invoices issued by limited liability companies in the 20 days before a business enters into bankruptcy are treated as administrative expenses of the procedure itself in order to ensure that bad debts do not escalate (ACCA 2013).

Table 10.1: The institutional context of late payment

Country	Getting credit			Enforcing claims			Resolving insolvency		
	Depth of credit information index (0–8)	Credit registry coverage (% of population)	Credit bureau coverage (% of population)	Time to enforce (days)	Cost (% of claim)	Number of procedures	Time to resolve (years)	Recovery rate (cents on the dollar)	Creditor participation index (scored 0–4)
Bangladesh	0	0.9	0	1442	66.8	41	4	25.8	1
Brazil	7	52.5	63.6	731	16.5	43.6	4	25.8	3
Cambodia	5	0	29.3	483	103.4	44	6	8.2	3
China – Shanghai	6	33.2	0	406	15.1	37	1.7	36	1
China – Beijing	6	33.2	0	510	17.5	37	1.7	36	1
China – Hong Kong SAR	7	0	96.1	360	21.2	26	0.8	87.2	3
Cyprus	4	0	6.8	735	16.4	43	1.5	70.5	2
Czech Republic	7	6.4	76.6	611	33	27	2.1	65.6	2
Ethiopia	0	0.2	0	530	15.2	38	1.8	38.3	1
Ghana	6	0	14.1	710	23	38	1.9	24.3	0
India	7	0	22.4	1420	39.6	46	4.3	25.7	1
Indonesia	6	46.4	0	471	115.7	40	1.9	31.7	1
Jamaica	6	0	10.1	655	45.6	35	1.1	64.2	2
Kazakhstan	7	0	51.7	370	22	36	1.5	43.3	2
Kenya	0	0	4.9	465	47.2	44	4.5	27.1	2
Malaysia	7	56.2	78.6	425	37.3	29	1	81.3	3
Mauritius	7	71.9	0	519	25	34	1.7	67.4	2
Myanmar	0	0	0	1160	51.5	45	5	14.7	1
Nigeria	6	0.1	5.8	509.8	57.7	40.2	2	27.9	2
Oman	6	20.6	0	598	13.5	51	4	37.7	1
Pakistan	3	7.3	4.5	993.1	23	46	2.7	39.4	3
Qatar	5	23.3	0	570	21.6	43	2.8	56	1
Romania	7	12.3	46.6	512	28.9	34	3.3	30.7	2
Russian Federation	7	0	64.6	267	14.9	35	2	43	2
Singapore	7	0	50.8	150	25.8	21	0.8	89.7	2
South Africa	7	0	55.4	600	33.2	29	2	35.7	3
Sri Lanka	6	0	44.5	1318	22.8	40	1.7	42.4	2
Thailand	6	0	52.7	440	15	36	2.7	42.3	3
Trinidad and Tobago	6	0	67.4	1340	33.5	42	2.5	27.1	3
Uganda	0	0	4.9	490	31.3	38	2.2	37.9	1
Ukraine	7	0	48	378	46.3	30	2.9	8.6	1
United Arab Emirates	7	6.8	28.3	524	19.5	49	3.2	28.6	3
Vietnam	6	41.8	1.4	400	29	36	5	18.6	1
Zambia	7	0	7.3	611	38.7	35	2.4	39.3	3
Zimbabwe	3	0	5.8	410	83.1	38	3.3	13.8	2

Source: World Bank (2014).

11. What role is there for corporate reporting?

Like all financial intermediation, trade credit uses a great deal of both soft and hard information. In their international review published by ACCA, Collis et al. (2013) show that small suppliers see customers' financial reports as being of limited use in preventing late payment and/or defaults. Instead, information derived from financial statements only becomes an important part of credit decisions when medium-sized and larger entities contract with each other and with small entities, and even then such information is used indirectly, as incorporated in credit agency or credit insurer scores. These typically calculate accounting ratios and factor them into proprietary scoring models to arrive at credit scores and recommended credit limits. Studies on private company samples such as Ma and Martin (2012) demonstrate that access to better-quality financial information on customers tends to improve the cash balances of suppliers, and ACCA and CBI (2010) also demonstrate that using credit reference checks and other quantitative metrics increased SMEs' confidence in their credit policies, thus releasing cash for other uses.

While financial data can usefully inform trade credit decisions, users are not uncritical of the published figures. In Collis et al. (2013) report that respondents in different countries have claimed that inventory figures could be manipulated, and are not generally reliable. Figures for cash, investment and distributions (by way of dividends or owners' pay) were of more interest, as were turnover and turnover growth. As ACCA and CBI (2010) demonstrate, timing should also be a concern for users of financial information: in the period covered by that research, the age of nearly all information used in credit decisions, typically ranging from 21 to 37 weeks among UK SMEs, was about twice that of the information the businesses thought appropriate for their own management purposes.

Overall, Collis et al. (2013) suggest that there are three alternative 'credit technologies' underlying credit decisions among the countries studied:

- Model 1: in environments with a low level of formal financial or credit information and low levels of interpersonal trust, sales are heavily cash-based or rely on deposits, pre-payments and bank guarantees.
- Model 2: in environments with a low level of formal financial or credit information but reasonable levels of interpersonal trust, credit is provided disproportionately to trusted counterparties or those with a good reputation.
- Model 3: in environments with a high level of formal financial or credit information, businesses rely on natural credit reference monopolies and highly standardised credit checks to help screen potential customers.
- Model 3a: public credit registers obtain information from mandatory submissions of financial statements, and the quality of information can vary depending on reporting requirements – in the case of small companies it can be very poor while for unincorporated firms it is usually non-existent. Some countries (eg Finland) have markedly more relaxed traditions on corporate disclosure, which greatly enhances the potential of this model.
- Model 3b: private credit-reference bureaux obtain information from scarce public data and through voluntary submissions, at what appears to be a greater overall cost to all the parties concerned. Coverage of the business population and individual organisations can, however, be more complete.

One particularly interesting question in light of the findings of Collis et al. (2013) is to what extent the institutional context of credit information, creditor protection, enforcement of contracts and insolvency can encourage or discourage the use of trade credit. Using data on 195 country-years from the World Bank Enterprise Surveys (2004–14)[1] and from World Bank (2014), it is possible to attempt a very limited answer. A simple stepwise linear regression analysis suggests that only credit bureau coverage is a significant predictor of the extent to which manufacturing SMEs use trade credit to finance working capital ($p=0.000$). When it comes to financing investment through trade credit, however, credit bureau coverage remains significant ($p=0.000$), but credit registry coverage ($p=0.008$) and the time taken to resolve insolvency ($p=0.008$) also emerge as significant predictors. These early findings would suggest that model 3b, as described above, is consistent with SMEs' relative reliance on trade credit to finance working capital, while model 3a, complemented by efficient insolvency processes, may be more consistent with SMEs' relative reliance on trade credit to finance investment.

1. The datapoints used in this analysis refer to observations for an individual country in a given year. Multiple instances were included in the analysis for countries surveyed in more than one year; data on use of trade credit were was taken from the World Bank Enterprise Surveys, while institutional variables (eg on credit information or insolvency procedures) were taken from the *Doing Business* (World Bank 2014) dataset.

A ROLE FOR NARRATIVE REPORTING

If the value of financial information to suppliers is limited on its own, then ACCA would argue that narrative reporting can complement it in useful ways and should be made mandatory for limited liability companies. This is not a major departure from the duties of companies and their directors. Already, legislation around the world acknowledges that these parties should have 'due regard' to the need to foster sustainable relationships with their suppliers (ACCA 2013). At the time of writing, the UK government was consulting on a new system of reporting on companies' prompt payment records, to replace the narrative reporting requirements in place up until 2013 (BIS 2014a). In so doing, it acknowledged that past efforts to reduce late payment through mandatory disclosure requirements had failed, and it is relatively easy to understand why (ACCA 2013; BIS 2014a).

First, companies are able to manipulate reporting periods and conventions in order to present more favourable aggregate payment totals. Crucially, they can aggregate operationally critical 'core' purchases (see Chapter 1), which are typically paid for promptly, with 'non-core' purchases, which can be significantly delayed. Furthermore, reporting on payment times cannot, unless at great expense, distinguish appropriately between delays that are dispute-driven and otherwise, overdue and non-overdue, administrative and tactical.

Many assumptions about the benefits of prompt payment reporting are far from proven. Late-paying companies might not think twice about discouraging potential suppliers, either because they already have multiple suppliers on standby, or because it would be those suppliers with the weakest financials that would opt out first. Perhaps most importantly, however, investors and creditors may not penalise aggressive management of accounts payable. They might even reward it, as long as it appears to predict higher earnings in the short-term. Enqvist et al. (2014) find evidence of this correlation in the US and Greece, for instance, but not in Finland, a noted leader in the fight against late payment. Ukaegbu (2014) finds the same effect at play throughout key African economies. It is possible that countries making progress against late payment have found ways of breaking the link between profitability and aggressive accounts payable management.

A different approach to disclosure can, however, be more successful. Disclosures in strategic reports should aim to explain how the company is complying with its legal obligation to 'have regard to' the need to foster the company's business relationship with suppliers and customers, and therefore payment policies and practices, where material or outside the norm, should be disclosed. In the long term, ACCA would like to see reporting on this matter become aligned to the International Integrated Reporting Framework (IIRC 2014), and in particular to the notion of 'relationship capital', as applied to supplier–buyer relationships (IIRC 2013).

For more immediate purposes, however, there are three mechanisms that policymakers could consider:

- Payment times reporting could be used as a liquidity/stress-testing mechanism. The aim would be to demonstrate the extent to which the business typically relies on suppliers with long credit terms in order to finance its short-term liabilities, or how it would be affected if suppliers had to cut credit limits or tighten terms.

- Payment times reporting could be used as an estimate of the total value of credit the suppliers extend to the company. This would simulate the cost to the company of maintaining a conventional credit facility equivalent to the suppliers' credit over a financial year.

- A review of supply chain health could be conducted. Consolidation among a company's suppliers tends to reduce the buyer's bargaining power and may interrupt supplies. Hence any late payers that risk consolidation as suppliers abandon them, merge or go out of business would be penalised by investors. This proposal is very sensitive to reporting conventions, however – a company with a very complex supply chain and a large number of suppliers could easily disguise consolidation.

12. Conclusions and recommendations

This study set out to understand how trade credit and late payment work in practice, how businesses try to protect themselves from late payers, and what prospects there are for policy to improve the plight of businesses – especially SMEs. Its findings challenge some widely held beliefs on late payment but uphold others.

The findings of this international study suggest that 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.

At the intersection of all the factors feeding into late payment, the potential influence of governments can be substantial, as long as their efforts are realistic and broad-based. It is particularly important that governments and stakeholders coordinate their efforts against late payment at a sector level, rather than over-relying on individual major companies willing to act as prompt payment champions.

Suppliers themselves are not as helpless against late payment as some might think. ACCA members explain, however, that it takes a highly focused approach to give real protection to 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 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 to the extent 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.

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 consolidating a 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.

Finally, major buyers should sign up to sector-wide prompt payment commitments or prompt payment codes where available, and boards, as opposed to government liaisons 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.

Governments, as some of the biggest buyers of goods and services, need to lead by example in the fight against late payment. With access to the capital markets, most of them have no excuse for borrowing in this way from business. It is therefore encouraging that many governments have adopted rules that commit them to prompt payment or that attempt to cascade good practices down the supply chain. All governments should follow suit, and should use their clout as major buyers to effect non-regulatory change as well.

Two good examples of this effect can be seen when, in their own supply chains, governments embrace e-invoicing and factoring or supply chain finance (eg by removing bans on assignment clauses from their standard terms). The benefits, through easier financing and added certainty, do not accrue simply to government suppliers – by growing the market for such services and demonstrating their effectiveness, these benefits will cascade down to the private sector as well.

Governments can do more. They should consider how their tendering processes can create 'capacity events' in their supply chains: essentially forcing prime contractors to pay more promptly in order to secure capacity at more regular intervals. There is a balance to be struck between the efficiency of large, long-term contracts and the additional bargaining power shorter-term or more modular contracts can offer sub-contractors, but governments have scarcely begun to explore this.

On the other hand, governments' efforts to regulate trade credit between private enterprises and penalise late payment are well intentioned and provide some useful tools to suppliers, but they have not made a big difference to the incidence of late payment itself. Policymakers need to re-examine whether they are in fact regulating only for a small minority of cases – failed supplier relationships and insolvent customers – and whether putting the onus on suppliers to take cases to court is an adequate approach.

This is not to say that regulating for these specific cases is not important. There is good evidence that making the enforcement of contracts faster, by making the courts more efficient and providing alternative dispute resolution mechanisms, can stimulate the flow of credit and boost investment.

Enforcement can only work optimally if the courts can distinguish fairly quickly between businesses that are solvent and those that are not, and between businesses that are viable and those that are 'lost causes', and take quick action to ring-fence assets for creditors. Alternatively, US-style protections against dilution of 'latecomer' creditors can help.

In addition to their responsibilities for the legal infrastructure, governments have an obligation to help build the 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 consider how it can best provide investors with actionable information.

These proposals will not, in themselves, end late payment. Fluctuations in a firm's access to finance or the viability of different sectors, as well as the changing fortunes of individual firms, will continue to give rise to late payment even if good practices become more widespread. Nonetheless, good practices can start to erode the business case for late payment and create the conditions, such as greater access to alternative finance, that will reduce the impact of the remaining instances of late payment.

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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.

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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 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.

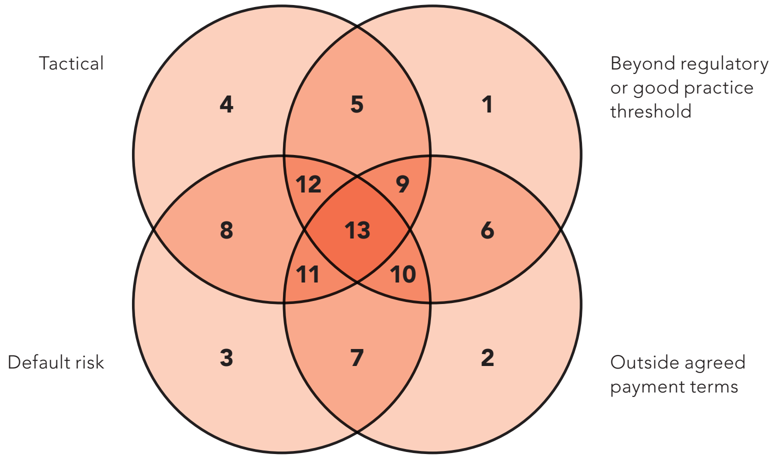
Ending Late Payment, Part 3: Reflections on the Evidence summarises ACCA's findings and issues a call to action for governments, financial services firms, large corporates and small businesses.

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.

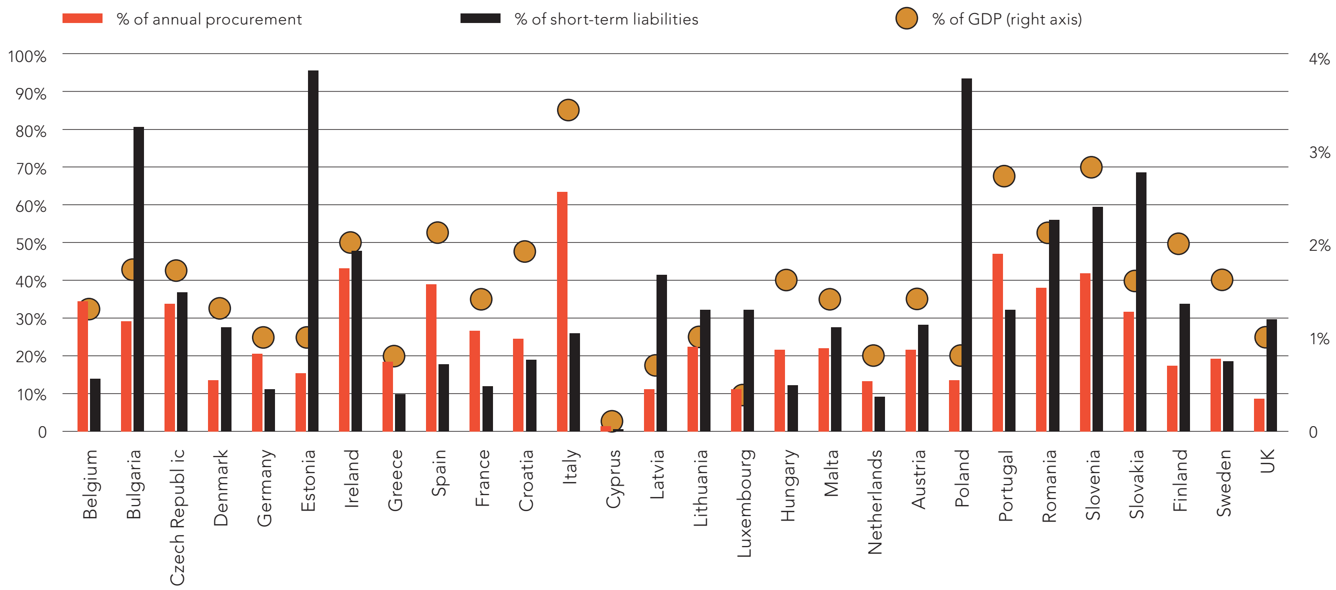
5. Are governments and blue chips different?

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.

ACCA

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The three reports are available from

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ACCA

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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