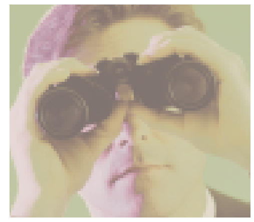


Looking for payment

GRAHAM BUCK AND JENNIFER CARRUTH SURVEY THE LATE PAYMENT LANDSCAPE.

Executive summary

As treasurers are expert at managing liquidity risk, a company with cashflow difficulties benefits from giving the treasurer the final say on making payments.

Commercial reality and ethics are as much a guide as the law in deciding how a company should proceed with its suppliers. Seeking legal remedy can sour a commercial relationship.

When a company begins to fall behind with its payments, it enters a cycle from which it is difficult to break free. The support of the bank in such circumstances varies across national boundaries.

That well-worn phrase "Your cheque's in the post" may be heard less often in this era of electronic transactions, but the problem of business customers failing to pay up on time has not gone away. If anything, it is growing worse. New research from BACS payment services has shown that, although the number of businesses in the UK dealing with late payments has fallen – from 59% in 2006 to 51% in 2007 – total late payments increased by £2.6 billion to £18.6 billion over the last year. In a recent survey carried out by the FPB, almost three quarters (74.7%) of respondents said that late payment severely affects cash flow and poses a "considerable threat" to the viability of their businesses. Delays caused by big business were deemed a particular problem for smaller firms.

The figures contrast with British companies' typical request that payment be made to them in no more than 30 days. As fears grow over an economic slowdown it seems likely the late payment trend will deteriorate. It will be interesting to see if legislation helps as companies scramble for cash. The Late Payment of Commercial Debts (Interest) Act 1998 gives business a statutory right to claim interest from other businesses for the late payment of commercial debt, and the European Commission's (EC) Late Payment Directive, which came into effect in August 2002, enables them also to claim reasonable debt recovery costs.

But relatively few companies make use of either, and Gordon Brown was recently urged to accelerate new rules for tackling late payments in the construction sector – a contributing factor in the late opening of the new Wembley Stadium and a threat to the timetable for Olympics 2012 building projects. Pressure is also applied through the Better Payment Practice Campaign (www.payontime.co.uk) and through payment league tables (www.paymentleague.com).

WIDESPREAD ACROSS EUROPE The problem is widespread enough across Europe to concern Brussels. The EC has claimed that one out of four insolvencies in Europe is due to late payment at the cost of 450,000 jobs each year. A report prepared for the EC Review of the effectiveness of EC legislation in combating late payments, declares that extended payment periods prevent Europe's small to medium-sized enterprises (SMEs) from making "adequate and timely investment in research and development, technology and the labour force". They also create "risks and market distortions" that undermine the ability of SMEs to take advantage of the single market. There are some 30 billion to 40 billion invoices issued each year in Europe, of which up to one billion result in default and become debt collection cases. The report also finds that 32% of SMEs participating in its survey raise their prices to factor in the cost of late payment, while 26% accept grossly unfair conditions.

When suppliers need to pay within 30 days but their customers only pay them within 90 days, the resulting

imbalance represents a significant extra cost of doing business. This is the cost of extra working capital – known as the payment period working capital cost (PPWCC) or marginal cost – needed to compensate for the difference between the payment periods. The PPWCC does not take into account the cost of financial uncertainty created by late payments, which may force a company to provision extra working capital at the expense of other items.

THE TREASURER'S STANCE So how should a treasurer approach this controversial issue? Their aim is to maximise cash, which means delaying payment is good and getting money in early even better. Attempts to extend payment terms will ultimately result in a hike in the unit cost of the product or service being bought. The treasurer can help establish the "sweet spot" – namely, the best balance between cash on the balance sheet (if you don't pay up, you're cash-rich) and the point where the profit and loss account begins to suffer as delay pushes up the unit price.

A number of factors must be considered to find where this sweet spot lies and bridge the two. This is determined by the cost of funds for both the supplier and the buyer and there are underlying commercial considerations.

For example, once the purchasing company has established the new payment terms, it will work on getting the product or service cost reduced, which involves some tough negotiating.

Although treasurers can help in bridging the gap between the two parties, it's outside their sphere of activity to be actively involved in negotiations between buyer and supplier. But treasurers are increasingly involved in other areas by virtue of their growing levels of responsibility for the company's supply chain and working capital ratios.

The latter are often regarded as value drivers for the business – for example, net days paid stock, which shows that the stock is often sold by the company before it has paid its supplier's invoice.

The credit crunch comes as companies are attempting to reduce their number of suppliers and squeeze out savings, forcing longer payment terms on those they do retain as a quid pro quo for more business.

The issue of late payments is likely to move even further centre stage as we enter a more volatile period. For small suppliers, the outlook is worrying with an already tight squeeze set to intensify.

ETHICAL ISSUES Nobody actually likes parting with their money to pay a bill, but most people accept that they have a moral responsibility to do so. Timing, though, is a trickier issue. While there is a strong argument that a payment should be made when it is due, there may be plausible reasons for businesses to delay paying for goods or services they have ordered and received. The ACT's ethical code applies to all members. Fundamental principle 7a (iii) in the ACT Directory states that a member must act "honestly and in good faith towards all those outside his own organisation who deal with him". It is not unreasonable to suggest that good faith covers the question of paying invoices within agreed time limits. So is there any situation in which a payment can ethically be made late? Philippa Foster-Back, Director of the Institute of Business Ethics (IBE), thinks not: "Late payment should be stamped out," she says. "It is illegal to not pay."

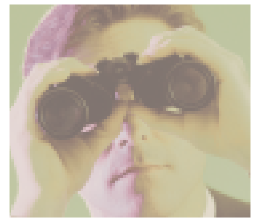
Treasurer-turned-cleric Justin Welby is the ACT's Members' Confidential Adviser on ethical and personal issues and Dean of Liverpool Cathedral and lectures extensively on ethics and finance. For Welby, the key question of whether it is unethical to delay payment is not the issue; instead, we should be asking where the power lies.

"When dealing with people who are dependent on you, late payment can be unethical," Welby says. "Those businesses that are smaller or less financially secure will suffer from delayed payment. But if late payment is between two financially balanced companies, it is acceptable. The ethical thing to do is to pay on time to those companies which are struggling."

ON THE CONTRARY Some argue that it is the responsibility of the supplier to ensure payment is made on time, and that it is naive to assume a buyer will pay unless chased.

"For people who are paid late, it's their own fault as they're not diligent enough to ensure the payment date" is the merciless verdict of one interim FD. Harsh? Maybe. Realistic? Definitely. Although customers have a moral duty to pay on time, suppliers also have an unwritten duty to remind their clients of the due date and to chase invoices. For treasurers, it is an important aspect of cashflow control.

Arthur Burgess is a former Treasurer of British Gas. He says: "When dealing with cashflow within a business or in your personal life, you have got to be able to look at yourself in the mirror the following morning. Treasurers ought to deal



with people equitably; you do not want to be too harsh or over-kind. In an ideal world, a contract will specify a payment date and there will be a contractual penalty for failing to meet it. Missing this date should be uneconomic for the supplier." Under the 1998 Late Payment Act, two parties can "agree any credit period that they wish" as long as this is "reasonable". But what may seem reasonable for one party, may not suit the other. According to an IBE report, smaller firms are often reluctant to use the law for fear of damaging the business relationship. This is where the Better Practice Campaign can help out. By signing up to it, companies can give a clear message to their customers and suppliers of their commitment to good credit management and paying on time. There are times when late payment can be seen as less morally reprehensible than at other times. If delaying payments to a financially robust organisation helps to secure the commercial survival of an enterprise, many would see that as a reasonable course of action. Burgess says: "It may be the balance of two evils. If a firm is on the edge of bankruptcy, it might be a lesser evil if it can postpone its payment rather than let the firm collapse."

MORAL RESPONSIBILITY Foster-Back believes one way to deter late payment is to reveal the culprits. She says: "Companies do work to certain standards. Everyone has a responsibility toward those with whom they do business. Smaller companies need to have the courage to name and shame those who are prone to late payment." She urges companies to seek advice if they are worried about late payments. She says: "Smaller businesses in particular should be advised that if they are having problems to look on the IBE website [www.ibe.org.uk] or to raise the issue with the chief executive."

One treasurer of a company with cashflow difficulties, who asks not to be identified, offers a personal experience of the dilemmas created by such a position: "As regularly happens at my group, you're confronted with the question, 'Do we pay the wages or do we pay our suppliers?' It's the hard choice you're regularly faced with when you're in a cash-restrained position.

"No treasurer enjoys paying an invoice late, even if there are some in the company who regard it as clever. But they don't have the experience of being on the other end of the phone from their supplier, who is likely to be begging you for payment when you simply don't have the cash to comply."

He believes that any company in serious financial distress benefits from having a properly qualified treasurer as part of the team. He or she will be in the position of having the final say on all payments, and able to override colleagues – a power that may need to be exercised on some occasions.

The ultimate decision rests on assessing the respective interests of all parties – creditors, shareholders, employees – and deciding a course of action that serves each of them.

What is ethically the right thing to do? An action that helps to keep the company afloat may be possible to justify, even if it results in keeping creditors waiting. While downright lying can never be condoned there are legitimate arguments for a cash-restrained company to hold back the release of sensitive corporate information by a day or two.

UNILATERALLY DELAYING PAYMENTS TO SUPPLIERS WILL IMPROVE WORKING CAPITAL BUT MAY NOT PRESERVE GOOD RELATIONSHIPS.

"Treasurers are well placed to deal with these moral and ethical conundrums," suggests the treasurer. "These considerations may be the drivers that lie behind making a payment late, when the reason appears to others to be sheer tightfistedness. The golden rule for any of us is liquidity. It's the biggest risk that we have to manage."

ETHICS ON A DAILY BASIS So the treasurer of a cash-constrained company has to refer to ethics on a daily basis in deciding the right thing to do. As another treasurer observes: "If we go bust, we may well take several of our suppliers with us, so it's in their interests to play along." It also demands regular communication with the companies to which money is owed and careful consideration of the words to be used. "Saying that you can't pay will spark panic, but if your company is cash-constrained you will need to explain it."

When a company begins to fall behind with its payments, it enters a vicious cycle. Although not too many treasurers have found themselves in this unenviable situation, it is likely to become more common.

Unilaterally delaying payments to suppliers or getting heavy with late paying customers will improve working capital but may not preserve good relationships, indeed it may even send out negative signals that the company is in trouble. A far better plan would be to start a multi-functional review of working capital taking in the totality of supplier and customer terms – quality, delivery times, pricing and discounts not just credit terms and payment methods, not forgetting the production and stock side of the equation. Any degree of credit given on sales means the company is exposed to credit risk and is something to be taken seriously and managed and controlled in a professional way. Treasurers can help here too since they are familiar with credit insurance, collateral or other hedging methods. In other words understanding and controlling working capital is potentially a high-profile multi-discipline project that can deliver a re-engineering of internal processes over and above any simple cashflow benefits. So, efficient working capital management needs senior management involvement and commitment across the organisation.

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For the ACT's ethical code, see page 337 of the ACT Directory 2008 or www.treasurers.org/membership/resources/EthicalCode06.pdf.