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Mind the Payment Gap

Siemens Financial Services

UK SMEs missing out on over £250 billion of liquid cash flow because of slow and late payments

Management Summary

- SMEs are an integral part of the UK economy, accounting for 47% of all private sector turnover[1]
- SMEs bear the brunt of late payments and long payment terms. Businesses (with turnover of under £1m) wait for 72 days for payment.[2] Businesses with an annual turnover of £1m-£10m wait on average 53-54 days,[3] and the largest businesses wait on average 48 days[4]
- A typical SME spends 130 hours a year chasing outstanding invoices.[5] The cost associated with this time taken is £10.8 billion per year.[6] Unpaid invoices account for 14% of SMEs' annual turnover.[7] These costs combined mean that SMEs are missing out on over £250billion of cash flow
- Outstanding bills are viewed as a drain on cash flow, yet finance products such as invoice finance can be used to unlock funding[8]
- Invoice finance is increasingly being seen by SMEs as a flexible and reliable tool to unlock working capital and now provides more funding than ever before to SMEs with funds used across the UK recently exceeding £20billion for the first time[9]

Compared to larger companies, SMEs tend to suffer from slow and/or late payments disproportionately due to their position typically towards the end of the supply chain.

SMEs account for 47% of all private sector turnover[10] and UK SMEs are missing out on £250 billion of liquid cash flow, when considering the value of UK SMEs' unpaid invoices and the costs associated with pursuing payment. Slow payments can threaten SMEs' ability to trade, stifle appetite for growth and recruitment and, in the worst cases, lead to insolvencies. As a consequence, leaving SMEs to cope with the problem is harming the economy.

Unlocking the potential cashflow could have significant benefits for economic growth. According to the Federation of Small Businesses (FSB), at the start of 2015 99.9% of UK businesses were SMEs. SMEs employed 15.6 million people and accounted for 60% of all private sector employment in the UK.[11] Nevertheless, despite their importance, waiting for payment of invoices is a significant problem for SMEs particularly as some large corporations look to extend their payment terms.

Organisations gauge how long companies are taking to collect payments by the Days Sales Outstanding (DSO);[12] a measure of the average number of days that a company takes to collect revenue after a sale has been made.[13]

The average DSO figure of UK companies (of all sizes) is said to be 59 days[14] (compared with a global average figure of 43.6 days[15] and a large company figure of 31 days[16]). Research from the Asset Based Finance Association (ABFA), however, demonstrates that SMEs[17] are waiting almost two weeks longer – an average of 72 days.[18]

The slow payment problem, broadly speaking, comes down to two primary causes, long payments terms and payments that are made late.

Long Payment Terms

90 day payment terms are becoming more commonly demanded especially from large companies. In 2013, a well-known pharmaceuticals company came under fire for introducing a new 90 day timescale for its suppliers, joining other companies such as iconic supermarkets, drinks companies and IT giants. The Forum of Private Business said this move demonstrated "scant regard" for small suppliers.[19]

In June 2013, one large company justified extending its payment terms to 120 days with the statement: "Extending our payment terms allows us to better align with industry and make sure we compete on fair grounds, while simultaneously improving transparency and predictability of payment processes."[20] This suggests that since a few large companies started the ball rolling, others are following suit. A chain reaction then tends to occur: if one company alters its payment terms it has impact along the supply chain. In 2015/16, 25.4% of British businesses had to take specific measures to correct cash flow; nearly 24% had to delay payments to their own suppliers.[21] And, since SMEs tend to be nearer the end of the supply chain, they tend to most feel the cumulative effect.

Late Payments

In its latest international survey of B2B payment behaviour, Atradius found that around 90% of British respondents had received payments from customers late. An average of 44.6% of the total B2B receivables remained unpaid after the due date, 3% higher than the previous year. [22] The average DSO of British businesses was two weeks longer in 2016 than 2015. This trend is persisting; one in four British companies expects its DSO to worsen in 2016-2017.[23]

In 2013, the then Business Minister wrote to all FTSE 350 companies urging them to sign up to the Prompt Payment Code (PPC).[24] The PPC, which was introduced in 2008, is a code that any business of any size can voluntarily commit to. It includes a 60 day maximum payment term for all signatories and aims to make a 30 day payment term standard practice.[25] In March 2013, FTSE 350 companies that had failed to sign up to the code were 'named and shamed'.[26] Despite these efforts, even now, the PPC still has only just over 1800 signatories,[27] and dealing with long payment terms is a continuing issue.

The European Directive on combating late payment in commercial transactions – another measure introduced in 2013 – states that payment debtors will be forced to pay interest and reimburse the reasonable recovery costs of the creditor if they do not pay for goods and services on time (60 days for business and 30 days for public authorities).[28] The reality, however, is that imposing the legislative solution is a last resort, to be used when the supplier/customer relationship is strained or has broken down.[29]

> *"Invoice finance plays an essential part of our business model. In order to properly plan and structure for our growth targets we need a constant stream of working capital, and invoice finance provides us with this."*
>
> David Shaw, Finance Director of Proton Group

The Impact of Late Payments

At the most basic level, late payments cost SMEs time and resources to track and push through. Research suggests that a typical small business spends 130 hours a year chasing invoices.[30] And when the cost associated with the time taken is multiplied across the number of SMEs in the UK the cost of this process is considerable. Research from 2015 demonstrates that in total it costs SMEs £10.8 billion to recover overdue payments, an average of almost £11,500 each[31] – a significant amount of money, particularly for SMEs.

It's not surprising, then, that late payments are a key concern for SMEs. 51% of small businesses cited cash flow, working capital and late payments as their main business concerns. Of these, almost a fifth claimed that the situation had worsened over the past year, and 15% of these firms said it is threatening their ability to trade.[32]

For some SMEs, however, the cost of late payment is even more acute. In a survey of 1000 SMEs, 23% reported that late payments had put them at risk of closure.[33] For a significant proportion that risk becomes reality; The Association of Business Recovery Professionals has said that late payment is a major factor in one in five corporate insolvencies.[34] Quite apart from these measurable consequences, many sources allude to the impact of late payments on SMEs' appetite for investment and willingness to hire.[35]

> *"It's understandable that when a sector is struggling, companies would look to give themselves longer to pay their bills. But this has a knock on effect for others. Our biggest expenditure by far is our wage bill, so to avoid paying staff late – or even worse laying them off – it's essential we bridge the gap between providing a service and being paid for it."*
>
> David Rowan, Managing Director, Epic International Ltd

The Invoice Finance Solution

The collective amount of potential capital locked up in unpaid invoices and the associated costs of chasing them is staggering. Unpaid invoices amount to 14% of SMEs annual turnover, or £252 billion.[36] Coupled with the costs associated with pursuing payment, a total of £262.8 billion is up for grabs.[37] Although many companies view outstanding bills as a drain on their cash flow, through solutions such as invoice finance they can be leveraged to unlock funding.

By using invoice finance, when a company invoices their customer, up to 90% of the approved invoice total is straightaway advanced by the finance provider, with the remaining 10% paid once their customer settles the balance. Whilst companies will still need to ensure the eventual payment of their customers' invoices, invoice finance provides the company with essential working capital so it can then invest in expanding its business without having to wait for bills to be paid.

Invoice finance is rapidly growing in popularity. According to BDRC Continental (an independent research consultancy) between 2011 and 2015, the percentage of SMEs using 'core' forms of finance (loans, overdrafts and/or credit cards) declined from 39% to 28%. Conversely, the use of other forms of finance (leasing, invoice finance etc.) has grown, with 17% of SMEs using one or more of these 'other' forms of finance in the last year. Invoice finance companies now provide more funding than ever before to SMEs with funds used across the UK recently exceeding £20billion for the first time.[38]

With access to working capital SMEs can look to invest in areas that have been viewed as optional extras or aspirations. For example, promotion, advertising and entertainment only account for approximately 1% of an SME's spend; employee benefits 2.4%, and business equipment 3%. Clearly, small businesses are focusing their efforts on paying for rent (4.6%) and employee wages (19.4%).[39] Nevertheless, with more cash at their disposal, taking on extra staff, more adventurous marketing, expansion into new product or service lines, or new territories could all be within businesses' grasps.

> *"Having that money available means it is ready to invest in business development. As we gain more customers we'll access more funds through invoice finance, which we can then invest in attaining even more customers and so it snowballs. We're really excited about the coming months".*
>
> Paul Smith, Managing Director, Triplex Distribution

Conclusion

For many years, SMEs have – quite rightly – highlighted the fact that they suffer from late payments far more heavily than their large corporate counterparts. When unpaid invoices are taken collectively, and added to the cost of the time and resources spent chasing their progress, the total value of the late payment problem for SMEs exceeds £250 billion. And the possibilities of what SMEs could do with this working capital are almost endless.

Rather than wait for a governmental resolution more and more small businesses are looking to leverage invoice finance as the answer. Having the majority of an invoice value advanced as soon as the invoice is issued means the business is free to deploy the capital to wherever it is required, whether that be staple expenses like staff wages, or more aspirational uses such as marketing or product development. Whatever they use it for, these businesses are realising that their unpaid invoices can be an opportunity rather than a burden. With more and more businesses joining the trend, and given the scale of influence that UK SMEs already exert, the impact on UK economic growth can only be good.

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