Make This Change to Stop Delayed Invoice Payments From Crushing Your Businesses

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A relic of the old economy is crushing small businesses with a $12 trillion-a-year financial burden. Even worse, firms are powerless to shed this onerous cost of doing business with other businesses and governments. But now as COVID-19 quarantines stifle orders and transactions like never before, the time is ripe to acknowledge the systemic problem.

The inequity, in economist terms, is trade credit. Most small firms in the B2B sector know it as delayed invoice payments. Here's how it works: A purveyor of artisanal jams sells hundreds of jars to a massive grocery conglomerate, then sends a bill that claims to be due upon receipt. But this claim is a joke.

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In the real world, this small-batch jam maker may be required to offer net 30, net 60 or even net 120 terms to secure the order—meaning payment is required 30, 60 or even 120 days *after* the goods are delivered. Even so, customers typically pay even later with no penalty. In fact, delayed payments are so common that some firms offer a discount on the net 30 invoice if the customer will pay in 10 days. This is a way for large customers to extract even more money from their

small business suppliers.

What happens in the gap between an invoice going out when goods/services are delivered and the money coming in? Every day it awaits payment, the small business must find ways to bridge this cash-flow gap to meet payroll, pay vendors, and cover taxes. At the same time, the revenue it has earned by delivering the product or service sits in its customer's bank account.

How small businesses become banks

Now this small business has become, in essence, a bank. Not only that, it's become a bank that issues no-interest loans to its customers. For weeks stretching into months, its valuable product is being used without payment.

Imagine what firms could do if they received their revenue immediately? They could be investing in growth, new product development or hiring more workers. Instead, they are treading water – or even going under–as their much-larger customers keep the cash on their own balance sheets and use it to fund their own growth.

The irony is these small business owners often don't realize – until it is too late – they've agreed to become free banks to their much larger customers. And by waiting for payment, they're suffocating their own growth. The problem isn't limited to makers of widgets or organic jelly. Consider service companies in which their employees are their top assets: Those that provide staffing, consulting, marketing or legal services. Their employees expect to be paid every two weeks and there's zero flexibility.

At the same time, big companies have every incentive to maintain the status quo; they use these extended terms as a cash management technique. All accounts payable proceeds they're holding is free money–they pay interest on debt but

not on their invoices from small businesses. Small businesses, however, don’t have that luxury or control.

More than the CARES Act

U.S. businesses have about $4.5 trillion of trade credit outstanding, according to Federal Reserve data from 2019. Small businesses bear one third to one half of the burden as they often fall at the end of the supply chains. For some perspective, the much-heralded Coronavirus Aid, Relief and Economic Security (CARES Act) handed out a mere $2 trillion of aid this year.

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Think of it this way: Small businesses are giving away more to their big business customers than they received in loans from the government via the CARES Act. In some cases, it could be much more: Because trade credit transactions turn every 60 days — the time it really takes a net 30 invoice to get paid — the total volume of transactions is $12 trillion a year. It’s hard enough to build a successful small business without fighting a $12 trillion credit crunch. And the fact that small businesses, who have a high cost of capital are funding large businesses who have a low cost of capital is inefficient for the whole economy.

This long-accepted practice is killing smaller companies by creating cash flow gaps and financial duress. The coronavirus has only exacerbated the crippling impact — firms have much less cushion to fund operations while waiting for accounts receivable.

Immediate benefits

Reducing the time gap could have a near-immediate benefit to smaller companies. A study by Harvard and MIT business

professors recently reviewed the U.S. government's Quickpay reform, which slashed the payment period for some federal contractors to 15 days from 30 days. The study found that each accelerated dollar of sales led to an almost 10-cent increase in businesses' payrolls. Overall, the reform increased annual payroll by $6 billion and created just over 75,000 jobs in the three years following the reform, the professors found.

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Given that small businesses account for almost 65% of new jobs annually, consider how many more they could create if they were relieved of the burden of funding their customers.

Trade credit has a role in the U.S. economy but there is a better way to fund it than on the balance sheets of small businesses. Consider how the growth of big-box retailers exploded after the credit card system put consumer credit into the capital markets instead of leaving it on the balance sheets of mom-and-pop retailers. When retailers no longer had to fund house accounts and wait for their customers to come in each month and pay, they were able to grow exponentially.

In the *Mad Men* era, trade credit was a practical necessity; every invoice had to go through a cascade of corporate departments for paperwork and approval. Today, however, the technological revolution provides instant information and payment transfer. There is no logistical reason to continue the routine 30- or 90-day payment delays of a bygone era.

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