Integrating Trade Finance and Accounts Payable Automation: The Basics

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There are differing perceptions of what is meant by "trade finance". Many terms are used to describe it, such as supply chain finance, trade advance, dynamic discounting, and receivables purchasing. It is often associated with global trade and complex of letters of credit transactions. However, the reality is trade finance applies to every transaction between a buyer and supplier. This white paper will discuss the basic concepts and benefits surrounding trade finance, as well as how organizations can leverage accounts payable automation and payment technology to achieve their cash flow and funding goals.

What is Trade Finance?

Trade is defined as "*the action of buying and selling goods and services*". Unless payment is made immediately upon delivery, every trade interaction involves some form of financing. What differs is who is doing the financing and how they go about it.

Each transaction is financed by either:

- A supplier;
- A buyer;
- A bank or other financial intermediary.

In the most common and simplest form, a supplier extends trade terms to the buyer, such as net 30 or 45 day terms. The supplier delivers goods and/or services to the buyer and then submits an invoice for payment. In this situation, the supplier is essentially extending a loan to buyer for 30 days or more until the invoice is paid.

This type of transaction is referred to as an "open account" transaction, where a supplier allows its customer to buy on credit without a formal borrowing agreement. There is an open or unpaid balance on the buyer's account with the supplier, for which the supplier expects payment at a future date. The risk of default is borne by the supplier, because there is no security or formal guarantee of payment from the buyer.

Supplier Needs and Challenges

Although this structure places the credit risk burden on the shoulders of the supplier, effectively managing its working capital is often the greater challenge. Suppliers need to meet the cash demands of recurring, business as usual expenses, but face a gap between cash outlay for expenses and cash receipt from buyers. In today's economic environment, suppliers are faced with increasing operating costs and pressure on margins, making it difficult to meet the working capital needs of the business on efficient operations alone. In addition, funding business growth, including purchasing equipment or inventory, expanding or renovating facilities, hiring staff, etc., creates even greater demands for capital.

To accomplish its tactical and strategic objectives, organizations bridge working capital needs through different sources of funding, including:

- Internal cash reserves
- Bank financing (commercial loans, equipment financing, lines of credit, etc.)
- Financing via commercial and/or specialty lenders
- Debt issuance

The old adage "Cash is king" remains true for suppliers. The availability of liquidity, predictability of cash flows, and the cost of working capital are key issues for many supplier organizations. These traditional funding sources may not be sufficient to meet all of its working capital needs. The financial crisis of 2008 and 2009 emphasized this vulnerability, as credit and liquidity markets dried up. Trade finance solutions complement an organization's funding strategy, leveraging trade relationships as a means to obtain greater access to cost effective capital.

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"The actions of buyers put an even greater stress on suppliers, who face liquidity challenges. But supplier health and stability is critical to a buyer's success."

Buyer Needs and Challenges

At the same time, buyers are focused on addressing their own working capital and cost reduction goals. Wielding the power in most trading partner relationships, buyers have the ability to negotiate price reductions to increase efficiency, profitability and cost competitiveness in their markets. Buyers also have an emphasis on preserving cash, including negotiating extended terms with suppliers to 45, 60 days or beyond, to manage business risks in an uncertain economy.

For organizations that have bolstered their balance sheets, it raises the questions for CFO's of how to more effectively use the cash surplus in today's low interest rate environment. Although large, idle cash balances are under the scrutiny of shareholders, the fear of lack of access to credit markets, as well as reluctance to participate in long term investment options, remains.

Conversely, cash poor organizations are still in a tenuous situation. The actions of buyers put an even greater stress on suppliers, who face these liquidity challenges. But supplier health and stability is critical to a buyer's success. Buyer revenue and performance is highly reliant on its suppliers. Buyer sourcing initiatives drive cost out of the supply chain and put even greater dependency on key strategic suppliers, by consolidating providers, reducing margins and extending terms. Even if a buyer has effectively managed its cash position, supply chain failures could be catastrophic.

Trade finance solutions facilitate earlier payment to a supplier versus standard buyer terms, while addressing many of the needs of both trading partners. For suppliers, it leverages their receivables as an asset for cost-effective financing, while delivering more consistent, predictable cash flow. For buyers, it delivers a more stable supply chain, while addressing profitability and working capital goals.

Core Elements of a Trade Finance Program

There are a multitude of trade finance products available today in the marketplace. The numerous offerings, options and naming conventions can cause a lot of confusion and make it difficult to discern the different solutions. However, all variations tie back to a set of basic concepts applicable to any trade finance solution.

Who is involved?	Each trade finance transaction involves four participants: • A **Supplier** who sells goods or services; • A **Buyer** who purchases those goods or services; • A **Financier** who funds the transactions between buyers and suppliers; and • A **Processor** who facilitates processing of invoices, payments or financing transactions. In its simplest form, all roles in the trade finance transaction are performed by the buyer and supplier. However, additional parties may become involved, including banks and third party processors, as more complex supply chain financing options are utilized.

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"When the buyer collaborates as part of the solution, the buyer benefits from reduced costs, supply chain health and stability, and/or improved working capital management."

Who leads the effort?	Trade finance efforts can be driven by the buyer or supplier. With a **buyer-centric** approach, trade finance options are often introduced as an extension of an accounts payable, payment or procurement initiative, enabling new working capital solutions for a supplier. Or a buyer may have a strategic initiative specific to Supply Chain Finance, in an effort to gain greater discounts or further extend their days payable outstanding (DPO) beyond standard 30 day terms. **Supplier-centric** solutions are driven independently by the supplier, focused on its cash flow and working capital needs. Regardless of approach, the supplier must agree to the funding terms and pays a discount fee for early payment, while reaping the benefits of improved working capital. When the buyer collaborates as part of the solution, the buyer benefits from reduced costs, supply chain health and stability, and/or improved working capital management.
Who assumes the risk?	The **Financier** provides funding and assumes the risk underlying the transaction. The financier could be one of the trading partners (i.e. the buyer or supplier) or a financial institution, such as a bank, specialty lender or other financial services provider.
What is underwritten?	In evaluating that risk, the financier may underwrite the **buyer's or seller's credit**. Even though the supplier is paying the discount fee for accelerated payment, the financier is concerned with the buyer's intent and ability to pay. In some cases, the bank will look at the credit quality across the supplier's portfolio of customers. Based on the underwriting standards and corresponding risk analysis, the financier may only approve funding for a subset of trading partners and/or invoices that meet the funding criteria. Also, a supplier may only be advanced a portion of the invoice amount to fund a reserve in event of short payment or no payment by the buyer.
When is it funded?	Funds are advanced to the supplier when funding criteria are met, upon occurrence of a **trigger event**, such as: • Purchase order issuance • Goods shipped or services rendered • Invoice sent • Invoice audited • Invoice approved The certainty of buyer intent and/or obligation to pay reduces the financier's risk. Thus, financing based on an event earlier in the procure-to-pay lifecycle than "invoice approved" represents a higher risk to the financier and a higher cost of financing to supplier. Visibility to where the invoice is in this lifecycle and its status (e.g. approved by buyer, in dispute) is essential for a financier to manage this risk.

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How is it priced?	Discount rates for early payment can be fixed or variable. • **Fixed** pricing is a percentage of the invoice amount, predefined based on a static or average discount term. • **Variable** pricing is a percentage of the invoice amount that adjusts based on actual discount term. The discount term is the number of days from invoice approval[1] to buyer payment of the invoice at contractual term. Fixed pricing is based on an "expected" term and thus requires a good understanding of buyers' payment history, as well as applicability to future payments. Variable pricing is generally a better fit where there is a high degree of variability in buyer payment terms and practices.
Who is responsible?	The structure of the funding arrangement determines who is responsible to the financier, if the buyer does not pay the invoice at maturity. **Recourse** can be to the supplier or buyer. Buyer recourse involves securing a buyer payment guarantee or meeting the legal requirements of a true sale of the receivables to the financier.

Understanding What Solutions are Available

Although new solutions or variations continue to emerge in the marketplace, these fundamentals are applicable across all offerings.

Buyer-Funded Solutions

The foundation of trade finance is standard contractual terms negotiated between buyers and suppliers (e.g. net 30). The supplier finances the buyer between delivery of the goods or services and invoice payment. However, for many suppliers, financing the buyer puts a strain on cash within their organization.

Financing Option	Who Funds	Who Leads	How Priced
Standard Contract Terms	Funded by Supplier	Negotiated between Buyer and Supplier during procurement process	Fixed, based on defined contract term
Trade Term Discounts	Funded by Buyer	Typically driven by **Supplier** to encourage early payment and reduce DSO	Fixed, based on defined discount window
Dynamic Discounting	Funded by Buyer	Typically driven by **Buyer** to increase discount penetration, in combination with A/P automation	Variable, based on actual days financed

Early payment or trade term discounts (e.g. 2% 10, net 30) have been historically driven by suppliers in an attempt to accelerate buyer payment and more effectively manage their working capital. Funded by the buyer, these early payment discounts are offered for a limited time window. If the invoice is not paid within the discount term (i.e. 10 days), the buyer isn't eligible to take the discount.

[1] Assumes invoice approval as the trigger event for funding. The start of the discount term is the funding event.

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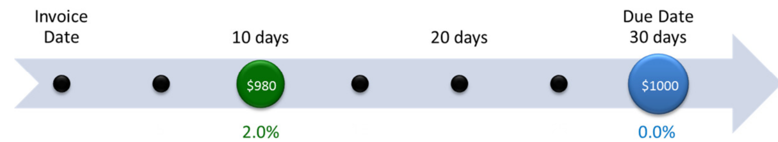
> *"Robust dynamic discounting programs can yield savings of 0.5% or more of annual spend to a buying organization. For an organization with $100 million in spend, these results can be close to $500,000 in savings, flowing through to the buyer's bottom line and increasing cost competitiveness."*

Often, the buyer is unable to process the invoice in time to take the discount. Invoice approval processes are too manual, the invoice is past due before it arrives in accounts payable, or there is an exception that requires resolution. In some cases, the buyer will take the discount anyway, with the supplier not realizing the intended cash flow benefits.



Dynamic discounting has evolved as an industry term to describe variations to traditional trade term discounts. The discount is considered dynamic or variable, because the price varies based on the days remaining in the contractual payment term. Often driven by a buyer's accounts payable or payment automation efforts, each invoice is evaluated to determine the actual number of days the invoice will be financed. The appropriate discount is applied, with discounts tiered based on payment windows or adjusted on a daily basis.

For example, a 2% discount for payment in 10 days represents an anticipated advance of 20 days, based on standard 30 day terms. If there is only a 10 day advance in practice, the supplier only pays a net of 1% (or 0.1% for every day advanced), with the dynamic discount reflecting the true financing period.

For buyers with available cash, funding supplier trade finance transactions offers a much higher return than other short-term investment options in today's lower interest rate environment. A buyer-funded discount rate of 0.1% per day is equivalent to 36% per annum. Compared with money market annual yields of less than 1%, allocating cash to fund $5 million annually in suppliers' working capital needs would result in interest income of over $73,000 per year. With an average of $208,000 in trade finance outstanding for 15 days, this is a sharp contrast to a 0.5% yield on the $5 million in cash in a money market.

Buyer-Funded Trade Finance

- $5 million funded annually
- $208,000 outstanding on average
- 1.5% for 15 days advance
- 36% annualized rate
- $73,000 in annual interest

Money Market

- $5 million in cash
- 0.5% annual yield
- $1000 in annual interest

Robust dynamic discounting programs can yield savings of 0.5% or more of annual spend to a buying organization. For an organization with $100 million in spend, these results can be close to $500,000 in savings, flowing through to the buyer's bottom line and increasing their cost competitiveness.

Bank-Funded Solutions

Depending on the buyer's cash position, there is a limit to the supplier trade finance volume that a buyer will be willing to fund versus its own demand for cash within its business. However, whether cash rich or cash poor, the buyer still has a vested interest in ensuring the health and stability of its supply chain, which is critical to its own financial health and growth. **Buyer-centric**, bank-funded solutions provide additional options for suppliers outside a buyer's discount appetite.

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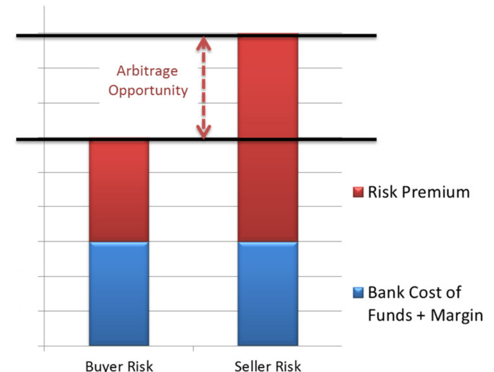
"By leveraging the buyer's credit, the supplier is able to obtain accelerated payment at more competitive rates, and at higher levels, than it may be able to obtain through traditional working capital loans and other financing options."

Even if the buyer doesn't fund the transaction directly, it can still support the supplier in obtaining its funds faster and more predictably. Known by variety of terms, including Supply Chain Finance, Advance Funding, Reverse Factoring, Payables or Supplier Finance, the solutions are all focused on the buyer's involvement in supporting its supply chain. Similar to a Commercial Card product, **advance funding** solutions leverage a buyer's credit, allowing a supplier to secure lower cost funding than it could independently.

Financing Option	Who Funds	Who Leads	How Priced
Advanced Funding with Fixed Discount Rate	Funded by Bank	Buyer-driven providing supplier with lower cost financing, based on **buyer's credit**	**Fixed**, based on average days financed
Advanced Funding with Variable Discount Rate	Funded by Bank	Buyer-driven providing supplier with lower cost financing, based on **buyer's credit**	**Variable**, based on actual days financed

A discount or financing rate is comprised of the bank's cost of funds, a profit margin and a premium to compensate the financier for the risk associated with funding the transaction. Where the buyer's credit quality exceeds the seller's, there is an arbitrage opportunity between the rates at which each organization can obtain financing. By leveraging the buyer's credit, the supplier is able to obtain accelerated payment at more competitive rates, and at higher levels, than it may be able to obtain through traditional working capital loans and other financing options.

A supplier will evaluate the bank-funded solution against its weighted average cost of capital (WACC)[2], i.e. its average cost of obtaining working capital from other sources. For example, a differential of 3% between a buyer-supported, advance funding rate and the supplier's WACC is $150,000 in annual savings on every $5 million in receivables advanced.



Integrated with an invoice and payment automation platform, an advance funding structure is a natural extension of a commercial card program, extending working capital options to suppliers across a broader spectrum of payments. With both fixed and variable pricing options, an advance funding program has the flexibility to accommodate suppliers with different terms, WACC and average transaction sizes across industries. It may also be combined with buyer DPO extension strategies, in order to offset the supplier impact of longer payment terms.

The best practice is to advance funds based on an approved invoice, with a buyer guaranteeing payment to the bank at maturity for all approved invoices. The buyer has an obligation to pay the bank whether the invoice is financed or not, and is typically assessed a late payment processing penalty for delinquent payments. This structure avoids the treatment of the accelerated payment from the buyer to the supplier as a loan versus a trade advance.

[2] Weighted Average Cost of Capital or WACC represents a firm's cost of capital proportionately weighted between capital sources and long term debt.

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Also available are **supplier-centric**, bank-funded solutions, where the supplier pursues funding independent of the buyer's participation in the process. In this case, the supplier may have the financial health and stability to pursue cost effective financing on its own. Or, more frequently, the supplier may have limited or lack of access to financing options funded or facilitated by buyers. As with buyer-centric solutions, both fixed and variable pricing structures are available across options. The core difference is the recourse arrangement. Who does the bank go to if the invoice is not paid?

Financing Option	Who Funds	Who Leads	How Priced
Receivables Finance	Funded by Bank	Supplier-driven with funding based on **credit quality of the supplier**	Fixed or Variable
Receivables Purchase	Funded by Bank	Supplier-driven with funding based on **credit quality of its portfolio of buyers**	Fixed or Variable

In a **finance** structure (e.g. receivables finance, invoice finance), recourse is to the supplier. If the buyer does not pay the invoice, the bank is going to look to the supplier for payment. Consequently, the bank's decision to finance the receivables, and at what financing rate, is based on the credit quality of that supplier.

With a **purchase** structure (e.g. receivables purchase, factoring[3]), recourse is to the buyer with the bank purchasing the receivable from the supplier[4]. To protect their interest in the receivable, the bank has to meet the legal requirements of a "true sale" and obtain the buyer agreement for payment. Before purchasing the receivables, the bank is going to evaluate the credit quality of the supplier's portfolio of buyers, since it is the strength of those buyers that will affect the bank's risk and ability to get repaid. But the buyer's involvement is passive versus the collaborative structure of advance funding.

In addition, the bank will verify the integrity of the supplier and validity of the invoices to avoid any risks with underwriting fraudulent invoices. Many receivables finance and purchase arrangements will also involve reserve requirements to mitigate the financier's risk. With a reserve, the bank has a pool of funds to draw on in the event of a short paid, disputed or otherwise outstanding invoice.

Due to the greater risk and complexity to administer, these supplier-centric options are generally more expensive than buyer-centric solutions.

Leveraging Accounts Payable Automation as Foundation

Although the core concepts around supply chain finance are not new, manual processes for both trading partners and banks have historically limited the adoption and growth of supply chain finance products as a working capital solution. Within buying organizations, long cycle times and accounts payable process inefficiencies prevented invoice approval in time for buyers to take advantage of supplier discounts. For financial institutions, manually underwriting paper invoices increased loan processing costs and required them to underwrite riskier pools of invoices versus individual transactions.

These inefficiencies, as well as associated risks with lack of lender visibility and control, drove up financing costs for suppliers. Banks lacked the supporting infrastructure and technology to effectively implement trade finance solutions. As a result, these types of finance offerings were limited to specialty lenders. Often considered 'last resort' financing

[3] Some factoring arrangements are also structured with recourse to the supplier.

[4] A purchase is a loan secured by the sale of the supplier's receivables to the bank.

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options, these products were expensive and often carried a negative stigma for suppliers, implying a deteriorating financial health. This history of niche lending has limited general market awareness and understanding of today's market offerings.

However, the adoption of accounts payable automation solutions in recent years has changed the game. Driven by buying organizations to reduce their operating expenses, these technologies have enabled adoption of supply chain finance and resulted in the emergence of new trade finance solutions.

Electronic invoice processing and audit has dramatically shortened approval cycle times within discount windows, facilitating buyer-funded trade finance offerings. However, more than just improving timing, it has expanded the use of discounts and accompanying structures. Solutions with discount logic now allow the systemic capture of discounts for buyers. Versus manual processing of the past, business rules establish the criteria for when discounts will be taken, as well as eligibility. A CFO or Controller can define and automate the application of its cash management strategy, instead of being dependent on operational execution and decisions made within accounts payable.

New dynamic discounting capabilities have also expanded the scope of invoices eligible for discounts. Discount scenarios are more comprehensive and collaborative, allowing the discount amount to vary based on trading partner and the number of days until the due date. Consequently, it is no longer an all or nothing scenario. Buyers can still take advantage of discounts if they cannot make a 10 day turn. And suppliers only have to pay for the value of the cash flow acceleration they actually receive – versus customers that take the discount terms, regardless of timing. For buyers, it has allowed them to increase the penetration of discounts taken within their accounts payable portfolio, as well as fund processing costs. For suppliers, it has increased the value of the discount program towards their working capital goals.

However, the benefits of accounts payable automation extend beyond discount terms between buyers and suppliers. With electronic access to invoice data and the advent of automated financing platforms, the efficiency of financing a supplier's account receivables has increased, thus driving greater main stream bank participation. With visibility into whether or not a buyer has approved an invoice or is disputing it before financing, a bank is able to substantially reduce their risk.

In addition, with automation, banks are able to manage loan balances down to the invoice level, allowing them to finance the invoices that meet with underwriting criteria versus a riskier pool. Integration with buyer accounts payables processes has facilitated variable financing options for suppliers based on actual days financed, as well as payables extension solutions for buyers. Leveraging the electronic invoice detail and terms, banks can systemically calculate variable pricing terms allowing suppliers to pay only for what they get. These technological advances translate into lower financing costs to a supplier, because the bank is able to more effectively manage their risk.

Integrating Trade Finance in Practice

Although enabled by accounts payable automation, trade finance is not typically the main driver of change. These initiatives are focused on operational or procurement savings from migrating to electronic invoice processing and systemic audits, as well as the greater adoption of electronic payment programs. But, with the potential to drive additional cost savings and enhanced profitability, evaluating where trade finance fits within the organization's accounts payable automation strategy should be part of the early stages of the initiative.

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Evaluate your goals.

It is important to look at your organization's short term and long term objectives across accounts payable, procurement and finance.

- What are our cost reduction and profitability goals? Can they be achieved through accounts payable automation? What are the other cost drivers?
- What are the strategic sourcing initiatives? How does that impact supplier terms, margins and discounts? Are we consolidating supplier relationships?
- What is our current cash position and where do we need to be? How are we managing cash reserves and short term investments? What are the returns?

Asking these types of questions early in the process will highlight where objectives and actions across functional areas intersect.

Evaluate the risks.

Equally important is evaluating risks the organization faces and what it can do to mitigate those risks. What is the stability of my supply chain? What is the financial health of my suppliers? Is it changing? Suppliers at higher risk for working capital challenges include:

- Industries with higher weighted average cost of capital
- Industries with longer payment terms
- Industries with longer gaps between expense outlay and revenue receipt
- Industries with long invoice life cycles and complex audit requirements
- Industries with high capital requirements

All of these factors represent a potential for increased stress on a firm's supply chain, whether the organization is a manufacturer or service-based organization, and are amplified where there are supplier concentrations.

Evaluate the opportunities.

All of these considerations translate into opportunities for the buying organization. By assessing its current state and taking a broader view on its target future state, an organization can define a roadmap to achieve multiple strategic objectives over time.

When assessing invoice automation platforms, an organization should not only look at their operational requirements, but also compile procurement, finance and risk management objectives. Even if the implementation will focus initially on processing efficiency, a key consideration should be whether it can deliver on longer term goals.

- Does the platform have integrated trade finance capabilities?
- Or can it interface with a stand-alone trade finance platform?
- Does it offer both buyer- and bank-funded programs?
- Are the options complementary to my existing electronic payment programs?
- Does it capture needed data for business rules and systemic processing?
- Is it robust enough to handle dynamic pricing structures and supplier terms?
- How does it integrate with a supplier's process?

The right accounts payable automation platform can enable an integrated payment, financing and sourcing strategy. Suppliers benefit from greater and more cost effective access to working capital and improved cash management. Buyers benefit from better utilization of working capital, stable supply chains, reduced costs and improved profitability.

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