IRTA advisory memo

Guidelines & recommendations for barter exchange deficits

October 7, 2014 revision

I. Preamble

In 1995 IRTA commissioned the top ten international accounting and advisory firm, Horwath & Horwath, (now Crowe Horwath International) to examine whether the creation of exchange deficits represented a sound financial practice and whether the IRTA recommended guidelines restricting exchange deficits was reasonable and prudent. The 1995 Horwath report titled “Deficit Spending Limits of Reciprocal Trade Exchanges” concluded that reasonable deficit spending, within IRTA’s pre-determined guidelines, represented “sound commercial practice and is desirable because of the benefits to trade exchange members.”

The purpose of this memo is to define the parameters of reasonable deficit spending so as to provide a clear standard for trade exchange owners to follow.

II. Monetary Management Responsibilities of a Trade Exchange

The barter exchange must have the authority to assure adequate liquidity exists in the barter system by regulating the supply of trade dollars (money supply) needed to finance the smooth turnover of products and services being offered in the exchange. Simply put, there needs to be enough trade dollars in the system for members to be able to buy goods and services they wish to purchase. To perform this function, the barter exchange issues credit lines to credit worthy members which represents the main source of the money supply when the credits are spent in to the trade exchange. Exchanges will typically reserve the right to borrow trade dollars from the exchange via a permission clause in their membership agreement. When a barter exchange borrows trade dollars from the exchange and spends those trade dollars within the system it also increases the supply of trade dollars in circulation.

The key question is; What is the proper and prudent amount of an exchange deficit so as to provide an appropriate level of money supply elasticity and how is such a parameter defined? With too little money supply members are unable to buy, and with too much money supply members will not sell and the system will freeze-up. A properly managed deficit will provide the optimum level of liquidity in the system so as to maximize exchange member trading.

Two Types of Deficits

There are two types of deficits in a barter exchange system, exchange deficits and system deficits. The combined total of both types of deficits equals the total deficit of the system.

1) Exchange Deficits

Barter exchanges have a fundamental fiduciary duty to the members of their exchange to manage the exchange in a prudent manner. In addition to the trade exchange’s role as the financial exchange manager for the system, the exchange also acts a member of the exchange itself by buying and selling within the exchange. When an exchange manager purchases more goods and services from the exchange then trade dollars that it earns, the corresponding negative trade balance is known as an exchange deficit. In such case, the barter exchange is actually borrowing from the membership of the exchange collectively, and the barter exchange becomes the debtor while the exchange members are collectively the creditor. Owner’s personal accounts, employee trade accounts and/or inventory accounts in a negative position are included as part of the total exchange deficit.
IMPORTANT TAX NOTE: In the US, based on the accounting doctrine of “constructive receipt”, an exchange deficit is viewed as taxable revenue by the IRS for the fiscal year it was incurred. The exchange’s deficit created each fiscal year must be reported on the exchange’s tax return as revenue for the year it was realized. If your company has an exchange deficit for the prior fiscal year, your company will owe the IRS taxes on deficit amount at a tax rate of 34 percent.

IMPORTANT CAUTION: Exchange owners who fail to declare trade income to appropriate internal and/or external regulating authorities from personal or family trade accounts controlled by the exchange owners, or any other trade accounts that exist whereby the exchange owners receive a direct or indirect benefit, may be subject to criminal charges based on the legal doctrine of “larceny by conversion.”

2) System Deficits

Exchange system deficits result from write-offs for bad debt, insolvency or bankruptcy of exchange member accounts and result in more positive balances (liability to members of the exchange) than negative-balances (goods and services owed to the exchange which represent an asset to the exchange).

IRTA recommends that all exchanges create a “member loan fund”, (aka as a “bad debt reserve” account), to effectively save earned trade dollars to “zero-out” a member’s negative balance account if such account is uncollectible or insolvent. By maintaining a proper member loan fund barter exchanges are able to minimize system deficits because uncollectible negative trade balance accounts are off-set by a corresponding entry from the member loan fund.

A portion of trade dollars earned by an exchange from new member sign-ups, monthly fees, advertising or renewals can be deposited monthly in the member loan fund. The percentage of an exchange’s monthly earned trade dollars that should be deposited into the member loan fund varies based on the exchange’s overall deficit. A higher deficit requires a larger percentage of the exchange’s earned trade dollars to be deposited into the member loan, while a smaller deficit would require less earned trade dollars be deposited.

IMPORTANT TAX NOTE: There are two types of deficits; system and exchange deficits, system deficits pose the lesser risk purely from a tax liability standpoint.

III. IRTA Recommended Parameters for Exchange and System Deficits

IRTA studied numerous deficit control models used by leading reputable barter exchanges and obtained the opinions of the top accountants in the barter industry to arrive at the recommendations contained herein.

IRTA Deficit Standard:
2.5 to 3.0 times monthly annualized averaged trade volume, (calculated on one side only, either buy or sell)
Example: XYZ Exchange’s monthly annualized trade volume is 400,000 a month.
IRTA maximum recommended exchange deficit: 1.2 million

IV. Recommended Methods to Reduce an Exchange Deficit

Exchanges that exceed the recommended maximum deficit threshold of 2.5 to 3.0 times their average monthly trade volume should reduce their deficit by implementing the following actions:
1) Spend less trade dollars as an exchange.
2) Create new avenues to earn trade dollars such as selling advertising in your newsletter or website, purchasing inventory at a discount and re-selling it at market value or charging a fee on your members’ negative trade balances.
3) Maintain a healthy member loan fund to off-set the deficits created by members’ account defaults.

V. Conclusion

Excessive deficit spending by a barter exchange will cause serious liquidity problems in an exchange that threaten the financial stability of the entire exchange. However, properly managed exchange deficits that fall within the recommended IRTA guideline of 2.5 to 3.0 times the annualized average monthly trade volume (calculated only on one side) can increase trade volume and revenue by providing the right level of money supply sufficient to allow members to buy and sell freely within the system.

Exchanges that do not meet the IRTA recommended deficit guideline need to immediately implement the recommended deficit reduction methods contained herein to lower their exchange deficit to the IRTA recommended standard of 2.5 to 3.0 times their average monthly trade volume.